LEONOR MAGTOLIS BRIONES

PHILIPPINE PUBLIC FISCAL ADMINISTRATION

Volume I

- Public Fiscal Management
- Development, Revenues and Expenditures
- State Budgets

PHILIPPINE PUBLIC FISCAL ADMINISTRATION

VOLUME I

SECOND EDITION

LEONOR M. BRIONES

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FOREWORD

This volume on Fiscal Administration is a revision of a 1983 edition. It is now the principal textbook for fiscal administration and public finance courses supported by the Fiscal Administration Foundation, Inc. It is also used in leading Colleges and Universities like the University of the Philippines, Silliman University, Philippine School of Business Administration and St. Thomas Aquinas University.

It is now published in 2 volumes. Volume I covering - Public Fiscal Management, Development, Revenues and Expenditures, and State Budget, while Volume II covers Sovereign Debts, State Accounting, State Auditing and Government-Owned or Controlled Corporations.

James Madison, the third American president, a century and a half ago, so aptly warned that: "A popular government, without popular information or means of acquiring it, is but a prologue to a farce or a tragedy, or perhaps both. Knowledge will forever govern ignorance, and a people who mean to be governors must arm themselves with power which knowledge gives."

Indeed, farce and tragedy are already with us. And the government overload and fiscal stresses that confront the nation will stay with us for decades more. But it is never too late.

FAFI by promoting courses in fiscal administration has started to make financial management an integral part of public administration. There is no other way. A separate discipline for the public fiscal sector has to evolve from our very own efforts, to find its central place in government management.

From this small beginning, our schools, the bureaucracy, our policy makers, the governed, and most importantly, our youth, must join in to build the critical mass in our society which will possess that "power which knowledge gives."

The need for competence and courage, for fiscal managers, trained, tempered and educated in the art of government, is critical. It could spell the difference between survival or bankruptcy.

FRANCISCO S. TANTUICO, JR.
Chairman
Fiscal Administration Foundation, Inc.

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PART I

PUBLIC FISCAL MANAGEMENT

CHAPTER 1

OVERVIEW

I. WHAT IS PUBLIC FISCAL ADMINISTRATION

II. THE ANALYTICAL FRAMEWORK - the "Mixed" Economy

III. THE DEVELOPING COUNTRY PERSPECTIVE

IV. COVERAGE

OVERVIEW

I. WHAT IS PUBLIC FISCAL ADMINISTRATION?

Writers have defined public finance as that branch of economics which deals with the revenues and expenditures of governments and their impact on the economy. Public finance has always been considered part of economics. In recent times, however, with the emergence of the field of public administration, much interest has been directed towards the political administrative and management aspects of formulating, implementing and evaluating fiscal policy - hence, the term public fiscal administration.

Public fiscal administration generally refers to the formulation, implementation and evaluation of policies and decisions on taxation and revenue administration; resource allocation, budgeting and public expenditure; public borrowing and debt management; and accounting and auditing. If we view it as a system, it includes the environment, structures, systems, processes, and personalities involved in formulating, implementing and evaluating fiscal policy. Fiscal policy, of course, refers to the mix of policies on taxation, expenditures and borrowings for the achievement of government objectives.

The above attempt at a comprehensive definition would describe any public administration system, especially those with mixed economies involving two sectors - the public sector and the private sector. The current consensus, however, is that public fiscal administration systems in less developed countries (LDC's), while visibly patterned after those of industrialized countries, are actually different. One obvious difference is in goals and objectives. The obsession for and preoccupation with development (whatever its interpretation) as the overriding goal makes fiscal systems of LDC's different in more ways than one. Other obvious differences are in levels of economic development, historical experience, the scars and traumas of colonization, and politico-economic relationships which are maintained even after an LDC is purportedly independent. Suffice it to say at this point that if we were to define public fiscal administration for LDC's, the definition, in the second paragraph would be applicable, with the added phrase that development is the ultimate goal.

II. THE ANALYTICAL FRAMEWORK - THE "MIXED" ECONOMY

It would be ideal to have a book on public fiscal administration which deals with both types of economic systems: free enterprise and centrally planned economies. A free enterprise economy is theoretically characterized by perfect competition in the market. There are basically two sectors:

the private sector and the public sector. Ideally, the market mechanism is allowed to operate freely in the operation of the price system. However, it is now considered that even under a philosophy of the free enterprise, government intervention is necessary in running the economy. Hence, the term "mixed" economy to denote the combination of a market system tempered by government regulation. In popular political language, such systems are referred to as 'capitalist'. On the other hand, socialist economies are characterized by centralized state planning. The economic problems of production, distribution, consumption and full employment are not left to the operation of the price system but are managed through planning. This book uses the "mixed economy" as the analytical framework.

III. THE DEVELOPING COUNTRY PERSPECTIVE

The discussions on the chapters that follow view fiscal administration issues and problems from the perspective of LDC's. This view literally spells a world of difference. More and more people are accepting the fact that development strategies which have worked for industrialized countries may not necessarily be applicable once transplanted to LDC's. Theories, strategies and techniques have to be tailored to the specific conditions of LDC's. Gone are the days when students studying the experiences of industrialized countries would assume that if we follow their examples, development will only be just a matter of time and patience. The Development Decades which produced innumerable studies on the development process have totally changed this earlier outlook. Thus, the question that is always raised is, will it work for the LDC? The overall framework here is therefore public fiscal administration for LDC's.

Many LDC's, especially before the start of the Development Decades, had mechanically adopted fiscal policies of industrialized countries mainly on the assumption that these would work because these were successful earlier. Also, lending fiscal policymakers were educated and trained in the industrialized countries which, at that time, only had their experiences to offer as examples. In more than one instance, these exercises resulted in disaster. An effort is therefore made in this book to look into the specific application of fiscal policy strategies for LDC's.

Focus on the Philippines

In this book, attention is focused on the Philippines, for several reasons. Firstly, it is directed primarily to Filipino readers. Even the average reader might find the discussions of fiscal policy issues relevant and meaningful especially if viewed in the light of larger national concerns. Secondly, for students of public fiscal administration for LDC's, the Philippines makes an excellent case study. In recent times, the Philippines underwent a series of wide-ranging changes in fiscal policy formulation and implementation, as

part of a bigger package of administrative and political reforms. These were initiated after the declaration of Martial Law. Finally, the Philippine experience could be useful to other LDC's because it reflects many of the dilemmas and options faced by countries which similarly underwent a long process of colonization prior to formal political independence.

In most of the analyses in this book, focus is on the pre-, during and post- Martial Law years from 1960-90. The choice is deliberate. During the 1960s most of the fiscal policies were in line with the "balanced budget" principle. Under Martial Law, many fiscal policies swung from the traditional "balanced budget" outlook to an open policy declaration of deficit financing and increased public borrowings. An aggressive policy of taxation and revenue administration was vigorously pursued. All these activities were launched under the aegis of an integrated development plan which called for expanded expenditures to finance large-scale programs and projects. The impact of all these changes on patterns of revenues and expenditures is extremely interesting. What is even more fascinating are the questions which have arisen in the process.

Interestingly, under the Aquino administration, most fiscal policies which were labeled "anti-people" during the Marcos Regime were not only retained but actively perpetuated. The debt incurred by the Marcos government, even those dubious loans, were all legitimized by the present administration by paying them all. Those automatic appropriations which were deemed incongruent with democratic processes have been upheld by the Supreme Court. Moreover, procedures have been substantially maintained.

We decided on 1990 as the cut-off date for statistics because the latest available data during the period of the research was on this year. Because of the difficulties and delays in integrating and summarizing data at the national level, national figures and statistics tend to be behind by a year or two. Thus, most of the data used here are on and after the Martial Law years. As far as possible, we have tried to make comparisons with the pre-Martial Law period, where data are available and comparable. We have also used more recent data than 1990, whenever such were available.

IV. COVERAGE

The book covers what is popularly known as "the public finance cycle" consisting of major activities in public fiscal administration. These are: fiscal policy formulation, taxation and revenue administration, budgeting and expenditure, public borrowings and debt management, and accounting and auditing. These activities are not necessarily sequential. In most instances, these are undertaken simultaneously and, hopefully, in close coordination. the book covers these five major activity areas and various issues and

problems from the perspective of an LDC, using the Philippine experience as an example.

Chapter Descriptions

Volume I of the book is divided into three major parts. Part I which introduces the basic ideas in the book, is divided into five chapters. Chapter 2 traces the development of public finance institutions, using the experience of industrialized countries. It ends with John Meynard Keynes and his views on fiscal policy. In quite a number of LDC's, his ideas are still dominant, especially those on compensatory financing, deficit financing and the use of fiscal policy as a tool for correcting imbalances in the economy. Although industrialized countries have already gone into what is described as the "post Keynes era", many of his ideas are reflected in not a few LDC fiscal policies. Thus, a discussion of the impact of his ideas on LDC's is important. The chapter ends with the query whether LDC's will follow the pattern of the industrialized countries, not only in the development of public finance institutions but in economic development as well. The current thinking is that this is not possible since the experience of the industrialized countries is no longer replicable. Chapter 2 explains why it is so, and examines the implications of such view for LDC fiscal policies which are visibly patterned after those of the industrialized countries.

Chapter 3 tackles issues and problems in development finance and cites the Philippine experience. As mentioned earlier, the attainment of development goals has became the overriding concern of most LDC's. As interpreted in their development plans, such goals require massive investment for large scale projects designed to propel LDC's into developmental orbit. Dramatic increases in GNP were even anticipated in some instances. The problem that has emerged, of course, is how massive development programs should be financed in the light of the limited resources of LDC's. Chapter 3 assesses the strategies that LDC's have evolved, under the tutelage of former colonial masters and international financing institutions, for financing their development ambitions. It raises the issue on how effective such strategies have been and what the costs are.

Chapters 4 and 5 look into the political basis of public fiscal administration. Chapter 4 discusses the constitutional and legal basis for fiscal policy formulation and implementation in the Philippines. More recent Constitutional provisions on taxation are already included. On the other hand, Chapter 5 describes the close interrelationship between the political system and the fiscal system. This process is sometimes called as "fiscal politics".

Part II introduces the reader to the resource generation activities of the government through taxation and other forms of revenue. Chapter 6 explains the current policies on taxation for development and gives a descrip-

tion of the Philippine tax system. It identifies the basic dilemmas which are frequently faced by the policy makers who formulate tax policies for development purposes. Chapter 7 analyzes patterns of Philippine revenue from 1960-90. In the process, it raises questions on the implications of the trends in composition and structure of government revenues. A three-period comparative analysis is done: pre, during and post Marcos era. Chapter 8 looks into the activities of local governments in raising resources to finance their developmental activities. It pinpoints problems in national-local fiscal relations which have persisted in spite of efforts to pass laws and other measures to enhance local fiscal autonomy. The Chapter on the Metropolitan Manila Commission is no longer included for it is no longer existent. The new Metro Manila Authority (MMA) which replaced MMC has a different structure and component. Chapter 9 analyzes the patterns of expenditures of the Philippines from 1960-1990.

Part III covers another major area in public administration: government budgeting and expenditure policy. Chapter 10 surveys theories of the budget and their possible application to LDC's. The difficulties of LDC's in working out effective budget systems against the backdrop of unpredictable and oftentimes unmanageable economic crises are discussed. Chapter 11 describes the Philippine experience in shifting from one budget approach to another. It recounts the circumstances under which each budget approach was adopted. The chapter emphasizes that a change in budget approach does not merely imply a change in technique or process but also in perspective. Chapter 12 discusses the organizational aspects of Philippine budgeting and describes the process, which is then described in detail in Chapter 13. The focus is not only in organizational processes but also in the informal interplay of political, social and economic factors.

Volume II of the book is divided into four major parts. Part IV focuses on what is perhaps the most controversial aspect of public finance for LDC's - public borrowings. This is an activity whose impact on LDC's has not been clearly established but ironically, this is also a fiscal tool which LDC's are using with vigor, whether as a matter of policy or as a result of circumstance. Perhaps, one can even safely say that public borrowing is the most significant activity currently pursued in public fiscal administration by most LDC's. This aspect of fiscal policy is fraught with controversy and disagreement not only among policymakers who accept it in one way or another but also among various sectors of society. The significance of the subject lies in the fact that it is obviously linked to the development efforts of LDC's. Borrowing is the primary tool used for financing development projects. Thus, it is a major component of development finance. Chapter 14 makes a survey of theories of public debt and their applicability to developing countries. It includes a discussion of issues on public borrowings which are confronted by the developing countries. A note on the national government domestic debt is attached to complement the discussion and to show how the foreign debt

resulted in the ballooning of domestic debts. Moreover, due to the worsening of the debt problem, studies now focus on debt management strategies. Chapters 15 and 16 are new chapters which highlight issues now becoming relevant due to their increasing impact on Public Finance. Both chapters touch on international constraints to public fiscal administration which include the fast growing influence of external forces on our economy.

The accountability aspect of the public fiscal administration, namely: (1) a technical description of concepts, theories and practices in the state accounting system and discussion of issues and problems in state accounting in the country, and (2) the state auditing in the Philippines, the developments in state audit and the current thrusts and priorities are covered in Part V (Chapter 17) and Part VI (Chapter 18), respectively. A detailed discussion of issues and problems in state audit is also included.

Part VII, (Chapter 19) covers government-owned and controlled corporations (GOCC) the activities of which are related with the problems of public administration. GOCCs play a major role in the economies of developing countries, in areas of monopoly power, capital formation, lack of private initiative, control in strategic sectors and ideological motivation.

CHAPTER 2

THE DEVELOPMENT OF PUBLIC FINANCE INSTITUTIONS

I. INTRODUCTION

EARLY PUBLIC FINANCE
- A. Ancient Finance: The Slave Societies
- B. Medieval Public Finance: Feudalism

II. THE BREAKDOWN OF FEUDALISM: BEGINNINGS OF CAPITALISM

- A. The Rise of Central Government
- B. Beginning of Capitalism
  1. Mercantilism
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III. CAPITALISM; PUBLIC FINANCE AND FREE ENTERPRISE

- A. Adam Smith
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IV. THE CRISIS OF CAPITALISM: KEYNESIAN PUBLIC FINANCE

V. THE MARXIST CHALLENGE: SOCIALIST PUBLIC FINANCE

- A. Marxism
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VI. THE IMPACT OF PUBLIC WESTERN FINANCE INSTITUTIONS ON LDC's

- A. Classical Public Finance
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- C. Will the LDC's follow the various stages of development of the industrialized countries?

THE DEVELOPMENT OF PUBLIC FINANCE INSTITUTIONS

I. INTRODUCTION

The development of public finance institutions merely reflects the development of organized society, particularly the state. Changes in concepts of what should be the functions and responsibilities of the state have to a large extent shaped concepts of what the goals of public finance ought to be. For after all, public finance raises and spends revenues for the functions of the state. These functions have been changing with the development of society. Thus, tracing the development of public finance institutions necessitates an examination of the development of organized society itself.

Students of western society identify the following stages of development: the primitive societies, slave states, feudal systems, capitalist, and socialist systems. On the other hand, other writers include the less developed countries as a specific stage of development towards either a capitalist state or a socialist system.

In this chapter, public finance institutions during the various stages in the development of society will be traced, with particular emphasis on public finance institutions in LDC's with mixed economies, which is the basic framework of this book.

EARLY PUBLIC FINANCE

If we are to trace the origins of public finance institutions, we would probably start with the beginnings of the state under the slave societies. Under the primitive societies, there was not probably much public finance to speak of. The primitive tribes were on a subsistence basis, with hardly any surplus. Whatever was acquired from hunting and fishing was immediately consumed. Battles over territories, the capture of defeated tribes who were turned into slaves, the development of settled agriculture and rudimentary advances in the production of goods led to the great slave empires of Asia, Africa and Europe.

The early public finance institutions of these slave societies served as foundations for modern institutions and practices. Ancient public finance provided some of the basic instruments of public financial management i.e., budget and expenditures, tax and revenue administration, and debt and borrowings. Medieval public finance further refined some of these concepts,

distilling their basic aspects by an expanded application to medieval public goals and conditions. It also introduced some basic tools like accounting and auditing.

A. *Ancient Finance: The Slave Societies*

The idea of financing public goals and activities is as old as the organization of public authority. Logically, the beginnings of public finance started from the creation of the state. The state was created by the necessity to protect and purportedly promote the welfare of man. Basically, the state was comprised of: the government, the people, territory, and sovereignty. Public finance was supposed to preserve the state and promote the goals of society. In particular it financed the activities of government.[1]

Expenditures

The role of public finance, therefore, became inextricably linked with functions of government. The traditional public finance-government functions unity originated from ancient times. To protect and maintain the state system, the government had to perform several vital functions. Among the most basic of these functions was the protection of the people, the territory and sovereignty from outside aggression. As the state was undergoing its initial stage of formation under the slave empires, it was subjected to constant aggression within and from outside. At the same time it had to perpetrate aggression to eliminate its neighbors, expand its frontiers and consolidate its territories. Ancient public finance was, therefore, characterized by enormous public expenditures for defense and aggression. The provision and maintenance of armies and navies were basic allocations of the public purse.[2] As a matter of fact, writers claim that public finance started with war activities. This was the largest single item of expenditures in ancient times. Regimes were literally driven into bankruptcy because of war expenditures. War was such a frequent preoccupation that peace has been defined as "an uneasy period between two wars."

A second primary function of ancient government was the preservation of internal peace, order and security and the administration of justice.[3] Considering the fact that a vast majority of the population might rebel any time, peace and order for the ruling minority was a primary concern. The administration of justice, of course, was for the free citizens and not for the slaves. Security, within and without, can therefore be considered as the main function of ancient governments; it therefore followed that much of public finance was poured into this activity.

A third function was the maintenance of a state religion. Religion helped stabilize and rationalize the ruling order in slave empires. It therefore played a major role in justifying the slave system. In slave empires, as in Egypt, the rulers were considered gods and goddesses; they were looked upon as human manifestations of deities and were considered religious as well as temporal leaders. Thus, elaborate bureaucratic structures were set up for state religions and massive temples were erected. These activities necessitated huge expenditures. In instances where religion was separate from the state, the former had its own financial system with high powers of compulsion.

A fourth function, the maintenance of the king and his household, was deemed the inalienable right of the sovereign. It was the people's obligation to provide him with revenues and he, to spend such (as a divine obligation), for anything he deemed good for the public welfare. This function has its modern counterpart in the general national government expenditures.[4]

Building and maintenance of public works was also a common activity in the slave societies. Roads, canals, irrigation systems, pyramids, and fortifications were considered public concerns to be financed from public resources.[5]

The term "public works" may not necessarily be descriptive of the massive structures which were built in ancient times since quite a few of them were really tombs of rulers. The tomb of Mausolus at Halicarnassus, the pyramids of Egypt, and the Taj Mahal are among the most famous examples. Other structures were monuments to the might and power of conquering warriors.

Finally, the other state concerns included limited goods and services like the distribution of free grain in times of famine as in Rome, public recreation, and physical education.

It can therefore be seen that the responsibilities of ancient governments were limited to a few major functions. Public finance expenditures were correspondingly limited to these activities. Compared to the present range of goods and services which modern governments are expected to deliver, ancient governments can be said to have a narrower scope of public service, and therefore of public finance. Still these early concepts of the responsibilities of the state laid the groundwork of our present public finance institutions.

Revenues

To finance its public functions, the State had to impose and collect revenues. Ancient taxes and revenues were generally crude and simple in form.

The slave state's revenues were ordinarily limited to: lootings and tributes from conquered peoples, war chests, fines, and direct taxes imposed on non-citizens of the State or on conquered peoples.[6] From this practice originated the vassalage taxes imposed on conquered provinces. Other revenues consisted of donations or gifts from the wealthy citizens of the state.[7]

Ancient governments had little need for direct taxes since they levied tributes on conquered peoples. The Greeks and Romans objected to any direct taxes but nevertheless were forced to practice direct taxation in times of emergency. Aside from the "gifts" of some citizens, ancient governments derived considerable revenues from the public domain -- particularly from agriculture and mines. Of the direct taxes in ancient times, the more important was the poll tax which was levied on Egyptian male population and on non-Roman citizens engaged in business. This developed into a kind of personal property tax in later times. One of the more popular taxes was the tax on inheritances. Originating from ancient Rome and Egypt, this direct type of tax provided elaborate exemptions. Significantly, it had a higher tax rate for childless couples and unmarried individuals, apparently in conformance with the ancient high regard for fertility, especially in Egypt.[8]

The most common sources of revenue were from the ruler's domain and tributes from conquered provinces. Trade and commerce which were potentially rich sources of revenues were not yet developed. The Greeks and Romans did not encourage entrepreneurial activities which were considered earthly and menial. The concept of economic prosperity was confined to ideas of division of labor and the beneficence of agriculture. Likewise, property taxes were not yet developed at that time.[9]

Ancient Greece did not levy taxes on its citizens without the latter's consent. This "assent principle," that is, direct taxation has to have consent of the people, was carried on to modern times. Further taxation was resorted to only in exceptional cases i.e, calamities and emergencies.[10]

Budgeting

Since the ancient governments had several functions to perform, it was logical that they had to apportion revenues for each of these functions. Budgeting was obviously exercised because of the need to allocate public revenues for specific purposes. Since the public budget was merged with the king's purse, there was no distinction between the public and the king's private expenditures.[11]

Borrowings

Public borrowings and debt management were unheard of. Although there was already a form of money lending, the ancient state did not borrow money even in emergencies. It only solicited gifts or levied limited taxes. The ancient state was relatively self-sufficient and public expenditures were usually borne by the citizens and non-citizens without recourse to loans.[12]

Auditing

State audit was also an ancient and respected branch of state administration. The principle of accountability for those in charge of government expenditures of resources from public funds is perhaps as old as organized government.[13] The principle of independent state audit was accepted in ancient Greek states.[14]

Since ancient public finance was limited to tax and expenditure aspects, state audit was primarily concerned with the maintenance and inspection of financial records to ensure the regularity of accounts and the legality of expenditures.[15]

Ancient audit activities were commonly performed by executive-judicial bureaucracies like the Ombudsman. The Control Yuan of ancient China and the Roman Tribunus Plebis were examples of such bodies enforcing public accountability with audit powers and responsibilities.[16]

To summarize, public finance in ancient time was understandably limited in scope and activity. This was because concepts concerning the responsibilities of the slave state were likewise limited to a few basic functions. Since war was the main preoccupation in ancient times, war expenditures got the lion's share of state financing. At the same time, revenues of the slave states were accumulated from war activities -- lootings, war chests, fines, and tributes imposed on captured provinces. Taxes, especially direct taxes, were few and were usually imposed in times of emergency. One of the richest sources of indirect taxes was the sale of captured peoples who were turned into slaves. At the same time however, the slave states of Greece and Rome initiated mechanisms of instilling accountability. Thus, even in ancient times, concepts of public finance were closely tied up with the development of the state, its main activities, and perceived responsibilities. The ancient state was anchored on slavery and war; accordingly, ancient public finance reflected this.

B. *Medieval Public Finance (395 A.D.-1500)*

The development of medieval public finance closely followed the changes in the political structure of the state during the Middle Ages. These

changes encompassed the weakening of the monarchy (central government) at the outset of the medieval period, the subsequent fragmentation of public authority resulting in the systems of feudalism, and the rise of limited monarchy at the end of the era. The shifts in the form of government were very gradual. Hence, the institutions of political authority and their economic, social and cultural ramifications were not only diverse but overlapping. Moreover, medieval conditions were greatly varied in scope and nature among the different European states.[17]

While medieval conditions reinforced some of the basic concepts in ancient public finance, the complexities of state governance greatly transformed the finance institutions in terms of form and application. In the face of changing conditions, the form and structure of taxes and other revenue instruments were adapted to varying sources and subjects of levy. While retaining its traditional purposes, i.e. for public concerns, public expenditure changed in terms of scope and composition. Accounting and auditing gradually acquired tangible forms. Public borrowings became institutionalized due to increasing expenditures of the government, evolving a semblance of debt management. Notwithstanding the diversity and complexity of the developments during Middle Ages, it was the system of feudalism which exerted the most significant impact on medieval public finance.[18]

Feudalism

Feudalism was essentially the system of economic relationship based upon land tenure, among the king, the lord, and the vassals. In England and France, it developed to its fullest, embracing as well the political, social, and cultural patterns of life. Some Western states while not fully feudal also experienced varying degrees of feudal life.[19]

The king still theoretically owned all lands within his domain. But he could not administer them directly. He found it convenient to charter parts of his land to his nobles. Moreover, due to the rising expenditures for defense against the invading barbarians, aggravated by his prodigal spending, the king was forced to grant lands in return for immediate revenues (aids or contributions). Inevitably, the public domain was divided into numerous feudal jurisdictions (fiefs) over which ruled, more or less independently, the feudal lords. The feudal lords became vassals to the king (suzerain), accepting the fiefs in promise for aids and soldiers. Many lords acquired more lands (manors) than they could manage or farm. Thus, they parceled the lands to sub-vassals or serfs to whom they granted permission to cultivate, accorded protection, and administered justice. In return, the serfs cultivated the lord's lands, served in his army and courts, contributed aids in money or services on special occasion, gave a part of their produce, and paid taxes.[20]

One feature of the feudal system, the suzerain-lord relationship implied the responsibility of the feudal lords to support the king with revenues for the latter's public expenditures. At least in France and Italy, however, the central government or monarchy was too weak to collect revenues on its own authority.[21] It was actually dependent on aids which were deemed contributions (not obligations) and justifiable only on emergencies or special occasions. In feudal England, the lords refused to give aids except in exchange for certain personal privileges or redress of grievances. For the lords, their fiefs immunity from royal control was the usual condition. For some people, some civil rights like freedom from vassalage were granted. In effect, this was a curtailment of some of the king's ancient revenue powers over the whole domain. His traditional rights of taxation and public spending were restrained or compromised.[22] Medieval writers like Thomas Aquinas (1225-1274) justified the diminution of the central government's revenue and expenditure powers. Aquinas taught that the king should live upon the income of the royal domain in ordinary times. Only in times of great emergencies such as war, he argued, should he levy taxes which should be moderate and just.[23]

More often, the king was increasingly forced to subsist mainly upon the income from the property he directly owned (the royal demesne). The king imposed fees on his subjects who hunted or fished in his demesne and imposed fines on trespassers. In addition, the king derived revenues from the bona vacantia, i.e., precious metals found, stolen goods, stray cattle and wrecked ships.[24]

The public functions of central government were usually confined to national wars and administration of the royal domain. Due to the weakening of central authority and its limited ability to finance its public functions, public concerns became the de facto responsibilities of the feudal lords. Government functions and inevitably public finance were parochialized.[25]

The feudal lords administered justice through representative local courts; provided protection against the barbarian and feudal rivals through local armies; supervised and regulated the agrarian and commercial activities; provided public entertainment and even minted coins for local usage.[26] The feudal lord became an important and active fiscal manager. He assessed and collected taxes from his serf. He levied license fees on merchants and traders who passed by his manor. He collected gross produce taxes, inheritance taxes and marriage fees for the upkeep of his court. Tolls on rivers, bridges or roads were also levied.[27] He also collected aids when his eldest son was knighted or his eldest daughter married, when he set out on crusades, and when the king requested contributions on emergencies.[28]

Where some national taxes were retained under the central government, revenue assessment and collection were confusing and in disarray

due to the absence of central accounting system and record-keeping. In effect of the central government or monarchy relied more and more on the feudal lords as local revenue agents. Consequently, the feudal lord had enormous powers over assessment and levy, not to mention revenue collection. Very often, the forms and amount of feudal taxes and levies differed from one fief to another, depending on the exercise of the lord's arbitrary revenue powers.

The lord vassal relationship continued to provide the basis for exercise of arbitrary power, although this time by the feudal lord. Like the king, the lords were not obligated to render a quid pro quo for their expenditures since they received revenues from the fief as a matter of royal grant or charter. The fief's budget was the lord's personal budget.[29]

As noted above, the economic foundation of feudalism was the land, inevitably, land-based taxes were common forms of feudal revenue. The English hidage tax, for instance, was based upon a farm size deemed sufficient to support a household. The taille, imposed on profits that the vassals derived from cultivation of the land, was a feudal variation of the land rent of ancient times. Gradually, the annual value (rental value) of land became the basis of assessment.[30]

The importance of land taxation was such that the English king, in one of his assertions of revenue powers, caused the preparation of the Domesday Book in 1085 listing all lands and owners for purposes of taxation. At best, the Book manifested of serious attempts of feudal governments to improve revenue administration.

Central governments borrowed occasionally but usually in small amount. Public borrowings were more or less a personal transaction between the monarch as borrower and the lender, who was ordinarily a wealthy trader. Public borrowings were difficult to secure because the king, under feudalism, had limited power to tax, thus to repay the loans. The uncertainty of royal tenure and the turmoils of succession posed the question of who would assume the obligation after the king passed away or was deposed. Medieval thinking also limited the practice of borrowings. The Church never fully condoned money lending and imposed certain restrictions on who should borrow and from whom. Loans were usually short-term, at high interest rates, with the king's personal properties like crown jewels or the royal domain as collateral.[31]

By way of summary on public finance in medieval times or feudalism, revenue raising and expenditures occurred at two levels - at the level of the king or the central government and at the level of the feudal lords. During this period, most of the traditional functions and prerogatives of the king were assumed by the feudal lords. The latter provided basic services and in the

process collected most of the taxes. The king was mainly involved in national wars and administration of his demesne. Compared to ancient times, his power to exact contributions was severely curtailed. The feudal system and its mode of taxation was transported by European countries to their colonies. Spain for example, superimposed the encomienda system, a variation of the feudal system on the Philippines, vestiges of which remain even up to the twentieth century.

Since feudalism was an economic relationship centered on land, most of the taxes were imposed on land-based activities and relationships. The feudal lord collected a wide range of taxes, fees, licenses and tolls. While impositions increased, the limited concerns of the state remained essentially the same as in the slave societies: war, internal peace and order, religion, maintenance of the ruler and his household and public works. The feudal period can rightly be credited with the development of one major public finance institution: taxation, which emerged as the major source of public revenue.

II. THE BREAKDOWN OF FEUDALISM: BEGINNINGS OF CAPITALISM

A. *The Rise of Central Government (1300-1500)*

The modernization of public finance at the national level developed simultaneously with the rise of central government. The requirements of strong central governments included the expansion and the rationalization of national finances. The growing cost of government compelled the post-feudal states to raise more revenues. The return of national revenue powers to central government led to the expansion of the traditional national taxes and the introduction of new ones.

The broadened revenue system and tax powers of central governments followed in the wake of the intensification of the fight for control over the public purse between the monarchy on one side and the representative bodies (comprised of lords) and the people on the other.

The taxes introduced during the post-feudal era were very numerous. Some of them were remnants of the feudal revenue system but expanded in scope and form. Most of them however, including new ones, were constantly revised partly due to changing economic and social conditions and partly because of the growing militancy of the taxpaying public.

One of the first post-feudal taxes reintroduced by the English central government was the poll tax. An ancient form of levy, it was expanded to include all male and female English citizens and non-citizens over fifteen years of age. It had elaborate classification of subjects and exemptions.

Different views and endless disputes over its features became the immediate cause of its repeal and revisions. Certain types of taxes based on circumstances of living i.e., thought to indicate one's economic and social status were also introduced. The hearth tax was assessed by the number of stoves and chimneys, and the window tax upon the number of windows in the houses. Both encountered serious difficulties. The hearth tax imposed in France in 1662, remained a part of French revenue system for many years. On the other hand, the English people resented such a tax on the ground that it involved invasion of their homes by the assessors. The window tax raised the problem defining a window and the people objected to such a tax on light and ventilation. In the course of post-feudal English history, almost every conceivable article of consumption was taxed through either customs duties or excises. A wide variety of sales taxes were levied on clothing, wastes, food and drink, wool, grains, tobacco, etc. The gabelle or salt tax was almost universal, but was resented everywhere. The net income tax was introduced for the first time in England in 1798 and became later an integral part of the British revenue system. This tax grew out of financial distresses occasioned by war. However, it was proportional rather than progressive, despite an exemption allowed for necessary living expenses. Its progressive features were not introduced until 1807. The income tax later became a mainstay of the revenue system of modern states. The development of the constitutional framework within which the strengthening of the nation-state was to be pursued, was another post-feudal factor which influenced public finance.

During the middle ages, the political and constitutional history of England was a history of struggle between the King and the Parliament for the control of revenue and expenditure powers.[32]

The Magna Carta of 1215 compelled the English King to grant civil and political liberties including the right to be consulted on matters of revenue collection. Arbitrary taxation which had been practiced by the early kings and feudal lords came to be restricted with the Carta. Feudal dues and tithes which the people used to pay were eliminated. More importantly, the Carta was a formal confirmation of the principle of national consent to taxation in the post-feudal times.[33]

The struggle between the English parliament and Charles I delved on the issue of whether the arbitrary revenue powers of the king still remained valid. The civil war that followed when the king was beheaded illustrated the victory of the consent principle. In the years that followed, the English kings were increasingly compelled to concede their arbitrary tax powers, culminating in the granting of the Bill of Rights in 1689 which provided once and for all the concurrence of popular consent through representative bodies on all tax levies and expenditures.[34]

In contrast, the French had developed no constitutional rights of taxation by consent. Understandably, France was one of the last to shake off the vestiges of feudalism. Whereas in England the fight for the control of the public purse was mainly accomplished by the nobles, in France the struggle was initiated and the victory achieved by the common people.[35]

The French Revolution in 1789 eliminated most of the existing taxes under the feudal system. The tithe or aid which was compulsory under the land-vassal relationship was abolished. The French taille and its exemption for the privileged clergy, wealthy bourgeoisie and the nobles, were voided. Adam Smith describing the taille, considered it "...to dishonor whatever is subject to it...".

The abolition of the feudal taxes was accompanied by a severe restriction of the king's expenditure powers. The Revolution provided a relief from the king's extravagance and national debts. The French National Assembly provided that no tax was to be levied without its consent. French public finance however, continued to be characterized by incompetent administration, confusion, and inadequate finances until the able administration of Napoleon instituted an adequate and efficient national financial system.[36]

The rise of central governments was also accompanied by circumstances which expanded public borrowings and introduced new debt management practices. One of these was the rising costs of government which compelled the government to borrow due to the still inadequate national finances. The development of industry and commercial trade activities, produced a money and credit economy and secular banks which provided commercial credit and settling of mercantile accounts. The wealthy merchant sector was more willing to buy government bonds. The development of constitutional and stable governments eliminated the uncertainty of loan repayments. Security of loans was also enhanced by the broadening of powers of taxation by the central government. Long-term national debts replaced the short-term royal borrowings. By the latter part of eighteenth century, public borrowings became a regular and important institution of public finance.[37]

The expansion of public credit however met mixed reactions from the early public finance thinkers, on its implications. Medieval writers like Diomede Carafa (1406-1487) and Jean Bodin (1530-1596) favored more the practice of moderation in government expenditures so as to realize a surplus or balance from the budget to be used for emergencies, rather than resort to borrowings.[38]

On the other hand, some thinkers like Sir James Stewart and Alexander Hamilton, welcomed public debt because, to them, it built up the country's credit. Hamilton for instance observed that public borrowings increased the active capital stock of the nations.[39]

The later part of the medieval period saw the heightened concern of governments for economy and prudence in tax impositions and public expenditures. This led to an increasing importance of the public accountability function in central governments among medieval writers. In emphasizing the importance of restrained expenditures, Carafa argued for the examination of the use of taxes by proper state officials. Jean Bodin advised a strict maintenance of a record of all government outlays to be kept and inspected.[40]

The extraordinarily elaborate and complex revenue system of the Middle Ages presented an urgent need for the central government to establish centralized accounting records and monitor revenues, borrowings, and expenditures in order to modernize the administration of national finances.[41]

The need for uniform taxation became one of the first concerns of the newly rising populist central government. The more modern features of tax systems and structures were slowly realized with the modernization and updating of permanent financial records which were "musts" for valid and effective bases for assessment or levy.

Increasingly, the need for technical skill in the collection and organizing of information became urgent. Near the end of the medieval period some methods of accounting and bookkeeping evolved. From the king's household arose the early formalized audit bodies. In France, a steward who was usually a chief deputy of the king was charged with the annual scrutiny of the accounts tendered by the local deputies. As in most medieval governments, he was powerful, sometimes acting as regent in the absence of the ruler.[42]

Later on, pressed by the need for more elaborate records- keeping and inspection, audit bodies began to bureaucratize. The English Exchequer for instance was staffed by financial and legal experts with specialized trainings. The growth of permanent records further enhanced revenue administration and the audit of royal revenue.[43] In Spain, the Justiciate of the Kingdom who served as the Ombudsman enforced public accountability functions through audit activities.[44]

It is noteworthy that the emergence of formalized audit institutions during this period was not confined to the West. In the East, public finance institutions also developed. State auditing was widely practised by the Korean dynasties. An inspector of the Korean ruler, who was the equivalent

of an auditor, carried a royal medallion in order to gain access to financial records in the course of his inspections.[45]

To summarize, the reemergence of central governments, particularly in Europe after the feudal period brought about significant changes in public finance institutions. The income tax emerged as the major source of national revenue. A wide variety of indirect taxes was also introduced. Also, the principle that taxes cannot be imposed without consent was integrated into the tax system. Accounting and audit institutions developed in the course of increased demands for accountability. Finally, public borrowing emerged as a major activity in public finance.

B. *Beginnings of Capitalism*

From 15th century onwards, the feudal system was gradually shattered by a rising tide of individualism. Prosperous merchants and craftsmen began to go against communal restraints.

Factories were established to provide goods for increasing populations. Technological advances enabled man to explore other lands for raw materials and food. Commercial trade increased with the establishment of colonies. Increased wealth accompanied by accelerated demand for goods and services expanded the domestic markets. These developments demanded new political and social systems which could accommodate the increased scope and complexities of modern life. The feudalistic system together with its parochial and static socio-economic and political structures slowly disintegrated. The nation-state arose, forged by a strong central government. Since the nation-state would have to be made strong, economic thinkers and statesmen concerned themselves with ways to make the nations economically strong and prosperous. From the extensive literature on this concern evolved three schools of thought: mercantilism, cameralism and physiocracy.

1. **Mercantilism**

Mercantilism refers to those policies especially protectionist and monetary, which the European states pursued during the 16th, 17th and 18th centuries in their efforts "to enrich a great nation by trade and manufactures than by the improvement and cultivation of land, rather by industry of the towns than that of the country."[46] The term has been expanded to embrace virtually all the economic policies of the period between the end of the Middle Ages and the emergence of laissez faire and capitalism.

Mercantilism evolved with the emergence of national states and the rise of central governments, the acceleration of economic enterprise, and the increase in colonial ventures.[47] The mercantilist state was primarily con-

cerned with the strengthening of the central machinery of government. This included the unification of heretofore numerous and autonomous feudal provinces and towns. In the economic sphere, this entailed the formulation of national policies providing for the regulation of industry and trade, elimination of feudal restrictions and the minting of national coinage. Secondly, the consolidation of mercantile states included the protection of the national sovereignty from external wars and internal dissension. Survival was achieved through the adroit use of alliances, intervention, and warfare. Any state which sought to preserve stability had to be prepared for war. It also had to protect its industries at home and its overseas interests. The cost of wars and the uncertainties of alliances compelled the central government to depend on its own economic strength through the promotion of its economy and enterprise. It also had to spend for large armies and mercenaries for protection and aggression.

But while central government were assuming the obligations, the ambitions and expenditures of a modern state, they were still largely dependent on the revenue system of a medieval feudal state. Mercantilists knew it was not easy to reform or adapt that system or to exact more revenues from the agricultural sector. Other ways had to be found to develop the industrial and commercial sectors, and tap these as revenue sources. The search for more and newer sources of revenues was a constant concern of mercantilist statesmen. Thus, statesmen used economic policies to achieve the ends of consolidating the state. Part of the pressure for mercantilist trends also came from the wealthy industrial and commercial sectors which sought government intervention in order to protect and promote their business interests.

This amalgam of forces and conditions gave rise to mercantilist policies which can be classified into those pertaining to the promotion of trade, and those for the protection of home industries. These mercantilist practices exerted large-scale influences on the public finance institutions of post-feudal Europe, including their colonial territories.

Mercantilist trade was mainly directed towards the accumulation and control of gold and silver bullions. Mercantile power and wealth was then equated with how much bullions the national treasury had or the citizens possessed. The valuable uses of money were countless: facilitation of exchange, granting of aids or subsidies to allies, payment for armies and preservation of reserves in the national budget for emergencies or wars, which served to popularize the bullion policies of mercantilism.[48]

Taxation

Regarding tax and revenue administration, the accumulation of specie (metal) enabled the central government to mint money for domestic use. The use of money in turn facilitated the collection of taxes, customs duties and

other revenues, thereby increasing collection and simplifying administration. By now, the central government was able to maintain large armies and navies, thus consolidating its power. It also enabled the government to establish large bureaucracies and civil service. Public expenditures, owing to the requirements of trade promotion, included as well the building and maintenance of state "merchant fleets." Revenue administration in the colonies emphasized the collection of taxes and other revenues in money metals. The mercantilist country also spent huge sums for its mining activities to extract gold and silver in the colonies.

To promote its home industries, the mercantile government granted subsidies in order to make the former more efficient and competitive. High tariffs were commonly imposed in order to protect local manufactures as well as to restrict the outflow of money. Mercantile fiscal and other incentives consisted of tax exemptions, infusions of capital funds, monopoly, and titles of honor to individuals. To rationalize its existing industries, the French instituted guilds to upgrade the skills of the workers of craftsmen. A variety of levies were then imposed on the guilds, prompting some at that time to observe that the purpose may have been to raise revenues rather than promote industries.[49]

Internal taxation was used to control the agricultural sector (which was considered only as secondary concern), to support industrialization thrusts. Internal tariffs were commonly used to regulate food supply and products for exports. Thus, high tariffs and low export rates were imposed when the agricultural sector produced an oversupply of goods.

To further monopolize trade, high customs fees and charges were imposed on foreign ships passing or docking at the mercantilist country. Tariffs were so high such as to prohibit foreign ships from profitable trading. In colonial trade, the export of goods to colonies were, for instance, by English ships which were to pass English ports and deliver the products to English trading companies. Imports from the colonies likewise followed the same route.[50]

Budget and Expenditures

Public expenditures at the time expanded enormously because of the wide-ranging mercantilist concerns of the government, the expansion of national government and bureaucracies, and the maintenance and protection of its ventures in the colonies. The accumulation of specie also gave rise to the development of a money economy which facilitated exchange and increased large scale business activities.

Accompanying the rise of central governments, the state increasingly indulged in spending for the burgeoning bureaucracy and the luxurious court.

Facilitated by the availability of gold and silver in the treasury, the government spent huge sums for armies and navies to protect the colonial settlements and ports, the domestic industries and the sea routes, and sent huge aids to its allies at war.

To sustain expanding economic enterprises, the state actively allocated public funds to aid the industries. A huge part of the state budget was commonly allocated for capital infusion, subsidies, and public works.[51]

Influence of Public Finance

Mercantilism had exerted many influences on public finance. First, it highlighted the necessity of state intervention in the economic life of the mercantilist country. Government intervention was a mercantilist doctrine. In addition, mercantilism demonstrated the capability of government to induce economic growth through fiscal policies. The doctrine of fiscal intervention of the state prompted Adam Smith to react with his laissez faire principle.

Second, the mercantilist emphasis on fiscal instruments to guide economic activities towards prosperity has broadened the uses of the tax and budget in the economic sphere. In addition, mercantilism expanded the uses of the public purse, beyond the traditional economic purposes to social and political ends. Even the scope of national public finance extended outside the traditional confines of the nation-state. Public expenditures, i.e., subsidies to colonies and high import taxes on foreign goods, demonstrated how the effects of instruments transcend national boundaries into the economies of other states. In another sense, mercantilism provided the opportunity to test the possibility and prospects of controlling other economies through fiscal measures. In time, the practice was used to good advantage by the Western states in their colonial ventures.

Thirdly, the concern of the mercantile state to preserve and increase its bullions by aggressive exportation of home products and the corresponding restriction of imports through high tariffs evolved into a set of fiscal principles known as the concept of "balance of trade." Despite its crude and inadequate applications due to the lack of adequate statistics at that time, the concept was developed and later refined into what is now a useful indicator of economic performance - the "balance of payments" concept.

Fourthly, the experience of mercantilism, exemplified by England and some Western States in the later part of the period, showed that mere acquisition of gold and silver was not the sole determinant of national wealth. As proven by England, the real economic prosperity of a nation lies within itself; the development of agriculture, simultaneous with industrialization proved to be the real bases of national growth and development.

Correspondingly, the budget shifted from its focused use in the trade to industrial enterprise and the utilization of the country's economic resources. Thus, the budget allocations of industrializing England changed in structure from huge allotments for trade to the agricultural and industrial sectors.

2. Cameralism

Cameralism, like mercantilism, was concerned with how to make the State powerful and wealthy. However, unlike the mercantilists who equally emphasized the accumulation of bullions through restrictive trade, cameralists were more partial to the development of a nation's internal resources through efficient administration and control of economic activities.

Cameralists, like Von Justi and Sonnefels, advocated the use of public finance institutions like taxation to direct the economy towards prosperity. The use of fiscal measures to control economic life was also deemed necessary by the cameralists. The cameralists school also emphasized the need to plan the system of taxation for it to become an effective economic instrument.[52]

3. Physiocracy

The Physiocrats were generally concerned with taxation and its stability and uncertainty. They agreed that the only way to institute a stable system of taxation was to base it on a sector which produced a net profit or surplus.

Through their analysis of the shifting and incidence of tax burden, physiocrats like Francis Quesnay and Jacques Turgot held that agriculture alone produced a surplus which formed the basis for taxation. To ensure the certainty of revenues, they argued, all existing taxes should be abolished and a single direct tax on the land-rent income accruing from agricultural cultivation be instituted. To them, the agricultural surplus which sustained the flow of income and goods in the economy, was the best foundation for a lasting system of taxation.[53]

III. CAPITALISM: PUBLIC FINANCE AND FREE ENTERPRISE

The development of capitalism, which had been gradually building up with the decline of feudalism, was accelerated by the industrial revolution. The advent of machines and numerous inventions which sped up the productive process radically changed not only in Europe where it started, but the world as well. Economic relationships changed from the land-based transactions to industrial relationships; from the relationship of the feudal lord and the tenant, to that of the capitalist and the worker. Ideas about the nature and functions of the state correspondingly changed. So did ideas on public

finance. The mercantilist philosophy of government intervention gave way to the laissez faire policy of minimum government interference. In feudalism, the known world revolved around the feudal lord; in capitalism, the man of the hour was the capitalist or the entrepreneur.

Under the philosophy of free enterprise, it was postulated that government interference in the economy should be at a minimum. Government services should be limited to the "basics" - a throwback to ancient public finance: defense, public works, maintenance of the bureaucracy, and limited services in education and health. All other services would be provided by the private sector, which, under perfect competition would result in the best goods at the lowest prices.

The era of capitalism was also ushered in by the "classical economists" whose works blazed in the trail for the economic ideas now prevalent in both the industrialized countries and LDCs.

A. *Adam Smith (1723-1790)*

"Classical economics" is the term usually given to the system of economic thought initiated by Adam Smith. His book on economics, An Inquiry Into the Causes Of the Wealth of Nations, published in 1776 became, 20 years after his death, the foundation of a new generation of writers, desiring to build a new science of political economy. Adam Smith's celebrated treatise laid the philosophical basis and justification for free enterprise or capitalism as the "ideal" political and economic system. His model of the economic man, which postulates that man is motivated by self-interest, provided the moral basis for the ascendancy of the capitalist.

Smith favored complete freedom for business enterprise and strong limitations on government. He advocated the policy of minimum governmental control on business activities (laissez-faire). Arguing that regulation only reduced wealth, he discredited the mercantilist theory.[54]

Smith devoted Book V of his work to "Public Finance." This became the primary authority on matters of taxation, budgeting and borrowing from the nineteenth century to the early part of the twentieth century. Smith put taxation on scientific and equitable basis. His theories regarding taxation in his famous canons - equity, certainty, convenience and economy established a set of principles which the state should observe in deriving its income more efficiently, yet equitably.

He strongly advised against the large scale borrowing. Pointing out the public finance is similar to the prudent management of a household. Smith contended that borrowing should only be resorted to in exceptional circum-

stances and should be repaid as soon as possible. He was consequently against deficit spending and advocated the concept of a balanced budget.

He also delineated and defined the proper functions of the state. For him government tends to be wasteful and irresponsible since it is not motivated by self-interest. Therefore, its activities should be minimized and the private sector should provide for the needs of society through the market mechanism. His doctrines advocated limited expenditures - for defense, justice and for the construction of a few indispensable public works.[55] He also urged government limitation of usurious rates of interest, and the supervision of banks.

The contributions of Adam Smith to capitalism are not limited to public finance alone. As a matter of fact, his ideas on the latter were largely shaped by his stand on the moral "rightness" of capitalism and the perceived functions of government under such a system.

B. *David Ricardo (1772-1823)*

Ricardo, a British economist, contributed in no small measure to the refinement of modern fiscal administration concepts and practices.

Ricardo is credited for his theory of distribution of tax burden which he applied in his extensive studies on the shifting and incidence of taxes. His concepts were to become one of the bases for the institution of equality and uniformity in modern taxation and the progressively of tax structure. His analysis of public credit led to an expanded view of the utilization aspects of public borrowings.[56]

C. *Adolf Wagner (1835-1917)*

Adolf Wagner, another important economist, ascribed to the state the function of eliminating the inequalities of wealth through fiscal measures. The use of fiscal policies for distributive goals in modern times partly owes its origin to Wagner.[57]

D. *John Stuart Mill (1806-1873)*

A laissez-faire advocate, John Stuart Mill contributed to public finance mainly from his correlation of the functions of the state to public expenditures. Mill contended that governmental action usually involved added expense which was usually defrayed out of compulsory contributions levied upon the persons and properties of the state. The burden of this expense, he argued, was one reason why governments would interfere as little as possible with the private affairs of the people.[58] He observed that "the business of life is better performed when those who have an immediate interest in it are left to

take their own course, uncontrolled either by the mandate of law or the meddling of any public functionary."[59] While Mill was strongly in favor of personal liberty, he justified however governmental intervention as in public expenditures for the welfare of the state.

IV. THE CRISIS OF CAPITALISM: KEYNESIAN PUBLIC FINANCE

Prior to the 1930's, the views of the great classical economists - Adam Smith, David Ricardo, John Stuart Mill and Alfred Marshall - were accepted without question. They espoused the view that labor could be fully employed continuously and the resources of a country could be utilized most efficiently if government activities were kept at a minimum. Government was not supposed to interfere with the free enterprise system, except for minimal regulatory functions.

However, the economic depression of the 1930's changed all these views. To their dismay, economists realized that industrialized economies would not respond anymore to the prescriptions of the classical economists. They discovered that economies under the capitalist or free enterprise system are subject to cyclical fluctuations and to the ravages of the inflation, stagnation and recession.

In 1936, the whole direction and emphasis of modern capitalists economics was changed by the appearance of a single book. The General Theory of Employment, Interest, and Money written by the English economist, John Maynard Keynes. In this book, Keynes demolished the dearly held economic views of Adam Smith and his successors. On public finance issues, he insisted that the government could and should influence the prices of goods and services, the amount of consumption, the degree of employment and the distribution of national income through taxation, borrowings and the purchase and sale of commodities and labor. Keynes developed the concept of fiscal policy as a tool for correcting imbalances in the economy. He emphasized its importance as a stabilizing and compensatory tool. Keynes demolished the view that government activity should be limited to a few basic activities; he insisted that public finance should go beyond mere maintenance of the governmental system and directly interfere with the workings of the economy. Thus, taxes for example would be objectives like influencing consumption and redistribution of income and wealth as well. Funds would be expended not only for the purpose of dispensing limited services but to affect income and employment levels as well. Borrowings would be engaged in not merely to balance the budget but to fulfill economic objectives like mopping up excess liquidity and transferring of resources from one sector to another. It could also be used to finance productive activities in instances where the private sector has been weakened and needs revitalization. Of all of Keynes' public finance views, perhaps deficit financing

was the most controversial at that time. It directly confronted Smith's hallowed views on the balanced budget.

The impact of Keynes on modern public finance is felt not only in the industrialized countries but in LDC's as well. His concept of aggressive economics and macroeconomics, and his basic terminologies - fiscal policy, monetary policy, deficit financing, compensatory financing - are now part and parcel of public finance vocabulary. These are standard tools which policy-makers of mixed economies - whether industrialized or developing - continually use, whether the objective be stability or development.

Keynes' ideas are said to have revolutionized public finance in the sense that he completely changed the earlier theories of free enterprise economists. He introduced the concept of government management of the economy within the context of the capitalist system. On the other hand, critics of the capitalist system say that he is a reactionary in the sense that his theories "saved" capitalism from collapse.

V. THE MARXIST CHALLENGE: SOCIALIST PUBLIC FINANCE

Sparked by the industrial revolution, capitalism spread quickly throughout Europe and the United States. In the process, production of goods and services rose phenomenally; market expanded and colonies increased. At the same time, the drive for profit resulted in exploitation of the unorganized working class. Even women and chiidren were herded into "sweatshops" under inhuman working conditions. The situation for example in England, moved satirist Jonathan Swift to write that children might as well be eaten, at the rate they were being exploited and made to work. With biting irony, he even suggested various recipes. At the same time, fierce competition led to giant monopolies and to wars over markets and sources of raw materials.

It was against the backdrop that communism emerged as a direct challenge to the capitalist philosophy espoused by Adam Smith. Karl Marx (1818-1883) wrote his Das Kapital, in answer to Smith's Wealth of Nations. It is important to have an understanding of the basic ideas of Karl Marx which laid the foundations for socialist public finance.

A. *Marxism*[60]

Marxist thought spans many different disciplines - history, economics, politics and many other subjects partly because of Marx's effort to present a comprehensive interpretation of society. Marx characterized his approach as the "materialist conception of history," maintaining that the key to under-

standing human culture and history was productive capacity, which means obtaining the means of subsistence by interaction with nature; in short, labor.

Labor is the instrument of human self-creation, a view Marx summed up in his Kapital: "Labor is a process in which both man and nature participate, and in which man of his own accord starts, regulates, and controls the material relations between himself and nature." To him, history is not the result of accident or is it shaped by the acts of great men much less by supernatural powers; rather it is created by human endeavor and is subject to observable laws.

Marx summarized historical materialism thus: "In the social production of their life, men enter into definite relations that are indispensable and independent of their will; relations of production (or property relations) which correspond to a definite state of development of their material production constitutes the economic structure of society, the real foundation, to which correspond definite forms of social consciousness. The mode of production of material life conditions the social, political, and intellectual life process in general."

Marx postulated three modes of production - classical (slave), feudal and capitalist. The latter particularly engaged in greater attention. He believed that capitalism, as it had succeeded feudalism, would likewise be replaced by a "non- antagonistic" mode of production, communion.

In the transition from feudalism to capitalism, the laborers were deprived of common lands and other forms of communal and small properties, a "process that transforms, on the one hand, the social means of subsistence and of production into Capital; and on the other hand/transforms/the immediate producers into wage laborers," dependent on others for their subsistence.

The capital system, despite its outward features, carries with it the momentum of class struggles. Marx and Engels assert in the Communist Manifesto that "the history of all hitherto existing society is the history of class struggles." Such struggle has been present in societies formed by various "modes of production" from the classical (slave) through feudalistic to the capitalist society. In each society, a minority of people own and/or control the means of production: land, money, labor, tools, etc. This minority composes the ruling class. The vast majority, comprised of the working class, own and control little or nothing, possessing only their capacity to work and produce what is largely appropriated by the former. Marx believed that the "exchange value" of objects (in contrast to "use value") was measured by the amount of labor expended in producing them. In the exchange between capital and labor, the wages of the worker had a smaller "exchange value" than the "exchange value" of the object produced, Marx observed.

In his theory of "surplus value," Marx explained how under capitalist production, the capitalist exploits the worker by constantly trying to extract the largest possible amount of "surplus" - that is, whatever value the worker produces beyond what is required for his basic needs - and at the lowest possible cost. The capitalist extends the hours of labor or makes labor more intensive or productive. Conversely, the workers consistently seek the highest possible wages, under the best possible working conditions, for the least possible working hours.

The conflicts engendered by these inherently opposed interests and the exploitative aspects of the relationship breed struggle between the working and capitalist classes. The workers may improve their wages, labor hours and working conditions but they remain subordinate, exploited and alienated from what they produce and from the productive process. In the course of many struggles and setbacks, the worker comes to acquire a revolutionary consciousness.

But the working class in the course of its struggles, confronts many forces and institutions that serve to maintain and defend the prevailing system. Some of the social forces are existing values, traditions, and ideas of the society which are largely nurtured by the bourgeoisie, the dominant class, and the extant mode of production. Social consciousness, Marx maintained, corresponds to the economic structure.

The legal and political superstructure also represents the bourgeoisie interests. For Marx, the state which should represent the collective interests of the members of society instead opposes them because it is on the side of the ruling minority. As the main agency of coercion, the state acts on behalf of the dominant class, as a weapon of class rule. Thus, the relation of production and the whole superstructure including the state become anachronistic fetters that bind the working class to exploitation and deprivation, and must therefore be abolished.

Marx believed that capitalism, in its insatiable drive for profit, constantly transforms and expands the productive forces. But the capitalists' rate or profit would nonetheless tend to fall. Competition would force them to replace human labor with machinery which is cheaper to purchase but which does not produce surplus value. The capitalist will also concentrate production in ever-larger units (centralization) which will result to greater interdependence between capitalists within a country and among other countries (socialization of labor). But this centralized and socialized production are primarily determined by the quest for private gain, and will "reach a point where they become incompatible with this capitalist integument." The contradiction between production and profit becomes more and more marked and creates increasingly more active economic, political and social crises. "The integument is burst asunder," declared Marx.

Although the capitalist system is doomed by its own inner momentum, the process of destruction would not be automatic. Marx believed it would require a revolutionary act to overturn the existing system.

The main force of revolution is the working class. Marx deeply believed that it is this class which experiences the adverse effect of the "contradictions" by which the system is irreparably plagued; and it will therefore come to acquire the consciousness which will free itself. "The emancipation of the working class must be conquered by the working class themselves," Marx declared.

Marx roughly sketched out his conception of post capitalist society. Communism could not be achieved immediately after the revolution, for "between capitalism and a communist society lies the period of the revolutionary transformation of one into the other. There corresponds also to this political transition a period in which the state can be nothing but the revolutionary dictatorship of the proletariat." The transition to communism would be marked by two central processes: First, the means of production would be owned by the society, and the products of human labor would no longer be directly appropriated by a single possessing class. Since the division of society into classes were largely determined by ownership or non-ownership of the means of production, this would pave the way for a classless society. Secondly, the state would be gradually abolished, in the sense that there would no longer be a political instrument for class domination and exploitation. Only in this "higher stage of communist society" would society be able to "inscribe on its banners: from each according to his ability, to each according to his needs."

Marxist contribution to our understanding of society in general and the political economy in particular has been immense. Marx's stress on the economic factor in society and his analysis of classes have had great influence on public finance in modern times.

B. *Basic Features of Society Public Finance*

1. The Primacy of Central Planning. Planning plays a crucial role in socialist public finance, in contrast to classic capitalist theory which places reliance on the market mechanism for the production and distribution of goods and services. Since there is only one sector in socialism - namely the state sector - central planning is feasible and has been proven successful. This is one aspect of socialism

which has become very attractive to LDC's who have set up economic planning machineries in the public administration systems. Because of these features, socialist economies are referred to as Centrally Planned Economies (CPE's).

2. The Role of Taxation in Revenue-Raising. Unlike the mixed economies where taxation normally accounts for most of government revenue, taxation plays a very minor role in socialist public finance. In the Soviet Union, for example, it is claimed that taxes comprise only 8.5% of total revenue. Revenue from the operation of state enterprises account for a great portion of state revenue, in contrast to the situation in mixed economies where many public enterprises operate at a loss.

3. Budget deficits. It is claimed that budgets of socialist countries do not have deficits but have surpluses of revenue over expenditure. This feature is in sharp contrast with deficits in mixed economies which are regular features of the budget.

VI. THE IMPACT OF WESTERN PUBLIC FINANCE INSTITUTIONS ON LDC's

The question might be raised as to why such a detailed account of the development of western public finance institutions was given. This is because all these institutions were transported to the LDC's at the time when they were still colonies to European countries and the United States. Such institutions can still be recognized in the public finance structures of LDC's at present. This is why it is important to understand their origin, and the context within which they developed, and which theories had the greatest impact on LDC's with mixed economies such as the Philippines.

A. *Classical Public Finance*

Of the classical writers, Adam Smith's ideas are still studied in the LDC's. His celebrated canons of taxation are often referred to and quoted. The canon of equity which advocates progressively in taxation is enshrined in Article VIII, Section 17 (1) of the Philippine Constitution. Unfortunately, in LDC's these canons are honored more often in the breach than otherwise. Smith's views on the balanced budget were upheld in the Philippines until after 1972 when deficit financing was announced in major policy statements.

B. *Keynesian Public Finance*

More than any other western economist, John Maynard Keynes had the most impact on public finance practices of LDC's. At the time that LDC's regained their independence after World War II, Keynesian economics was already firmly entrenched and widely accepted. Keynes' view that government should play a dominant role in running the economy fits in with the concept of the role of government in attaining development goals. The importance that he placed on fiscal policy functions was reechoed by LDC policy-makers in their own fiscal policies. Finally, his concepts of deficit financing and borrowing gave theoretical justification to the impelling need to borrow and to unbalance the budget in the frenzied race towards "development."

The current thinking among students of development economics is that Keynes' ideas are no longer relevant, even in the industrialized countries. However, a lag usually occurs between changing theoretical concepts and actual translation into fiscal policy. While the academicians are already denouncing Keynes, many of his ideas are still easily recognizable in current fiscal policies, even in the Philippines.

C. *Will the LDC's follow the various stages of development of the industrialized countries?*

This is a question I have always asked my students in Public Fiscal Administration and participants in Public Finance seminars for the past twenty-two years. Will LDC's automatically go through the same stages of moving from slave systems to feudalism and on to capitalism and industrialization? Happily, their answers have been changing. During the late '60's, students would answer that, yes, we are following the same pattern of development. The Philippines, for instance, has passed the feudal stage and is now moving inexorably to industrialization. At present, the answers of students are vastly different. They state that the experience of the industrialized countries cannot be replicated. True, the Philippines underwent a modified "slave" system but this process was interrupted by Spain before extensive kingdoms and empires could be consolidated. True, Spain brought over the feudal practices and established colonial finance in the Philippines. But, the big difference was that the financial system was for the benefit of Spain and not for the Philippines.

The experience was repeated later when the Philippines became a colony of the United States and later was occupied by Japan. The ordeal of colonization made the all-important difference and interrupted the process of development. The industrialized countries are the beneficiaries of colo-

nialism, the LDC's its victims. This is why the western experience cannot serve as a model for LDC's.

In the case of the Philippines, nearly 400 years of direct rule by Spain, four decades of "tutelage" under the United States and five years of occupation by the Japanese have resulted in the transfer of its vast resources and wealth to the colonizing country. Such transfer was facilitated by colonial finance. Furthermore, the Japanese occupation brought destruction and death in its wake. It is no wonder that by the time the Philippines launched its programs as an independent country, the coffers were practically empty, laying the door wide open to borrowing, political compromise and to a continuation of pre- independence economic relationships. The Philippine experience is not much different from those of other LDC's. The similarities between the public finance system of LDC's and those of other countries are more obvious than the dissimilarities. In the process, existing public finance institutions are increasingly subjected to scrutiny in terms of relevance and effectiveness in attaining avowed national development goals.

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[3]*Ibid.*

[4]*Ibid.*

[5]*Ibid.*

[6]Alfred Zimmern, The Greek Commonwealth (Oxford: The Clarendon Press, 1924), p. 289.

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[9]Bennet and Lippincott, *op. cit.*, pp. 7-8.

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[16]*Ibid.*, p. 118.

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[26]Encyclopaedia Britannica, *op. cit.*, oo. 150-152.

[27]*Ibid.*, pp. 151-152.

[28]Compton's Encyclopaedia, *op. cit.*, p. 99.

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[45]See COA Journal, Vol. 28, March 1982, inside front cover.

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ANNEX

COLONIAL FINANCE IN THE PHILIPPINES
- A SUMMARY -

Pre-Spanish Period

In the pre-Spanish Philippines, the government was patriarchal in form, with the barangay as the basic unit of government. Each barangay was a settlement consisting of 30 to 100 families, and like the city states of ancient Greece, were independent of each other. A king, called datu or rajah, rule each barangay, assisted by the elders who advised him on important matters, such as promulgation of laws, trial of cases, declaration of war, and negotiation of treaties with other barangays.

A direct relationship existed between the datu and his subjects. The subjects were required to pay a tribute, known as buiz, out of their produce and to render personal services to the ruler. On the other hand, the datu maintained peace and order in the barangay. Nobles and freemen were exempted from paying tributes and from rendering services to the datu except in case of war.

Spanish Period

For over 300 years, the Philippines was a crown colony of Spain. However, the Philippines was more of an economic liability than an asset to Spain. The colonial government was so incapable of supporting itself that the Spanish crown had to send from 1572 to 1810 an annual subsidy of about P400,000 to Manila for the maintenance of the Philippine Administration.[1]

The Philippines was for a time ruled by Spain through Mexico, until the latter won its independence from Spain in 1821. Spain then established a centralized government in the Philippines under the direct control of the home government in Madrid.

At the head of the centralized government was the Governor and Captain-General[2] who symbolized the knight and the majesty of the Spanish Crown. The Governor General performed great powers - executive, military, judicial and religious - which included the collection and administration of public revenue.

Two advisory bodies were created to assist the Governor in administering the Philippines. These were the Board of Authorities whose chief function was to advise the Governor-General on questions of unusual importance, and the Council of Administration whose main function was to deliberate on the governmental budgets, and on matters which the governments deemed proper to submit to it for opinion.[3]

In May 1583, the first Royal Audiencia was created in Manila in order to restrict the powers of the Governor-General and to protect the Filipinos from the abuses of the officials. It was a failure and had to be abolished. By May 8, 1598, a new Audiencia was set up, which continued to exist until the end of the Spanish Regime in 1898. The Royal Audiencia of Manila did not only function as a check on the powers of the Governor. Up to 1719, it took the reins of government in cases of vacancy in the gubernatorial office; and until 1861, it acted as an advisory body to the Governor-General. It exercised executive and administrative functions by sharing with the Governor the discharge of the royal patronage and by preparing an annual report to the King on the Philippine political and social conditions. It enjoyed legislative

powers by enacting regulations for the local governments and discharged financial authority by auditing the yearly accounts of the colony.[4]

For purposes of internal government and administration, the Philippines was divided into provinces and districts. Each province was under civil provincial executives called alcaldes- mayor. The alcalde-mayor exercised both executive and judicial functions, and supervised the collection of tributes in the provinces. The provinces were subdivided into pueblos, under a gobernadorcillo, ordinary called captain. The pueblos were divided into barangays or villages, under the chief called cabeza de barangay. The cabeza paid no tribute and his chief duty was to collect taxes in his barangay.

Taxes or tribute were exacted from the Filipinos as a recognition of vassalage to Spain. From the days of Legaspi until 1884, the Filipinos paid tribute in the form of a head tax. Originally, the rate was eight reales per family, payable in money or in kind. In 1602, it was raised to ten reales, and to twelve reales in 1851. One tribute was equivalent to one family consisting of husband, wife and minor children. Considered half tributes were married men over 20 years old and unmarried women over 25 years of age. Exempted from paying tribute were Spanish residents, Filipino officials, widows of Spaniards, the descendants of Lakandula and other royal Filipino rulers.

In addition to regular tributes, the Filipino paid one real for tithe, one real for the community and three reales for the church. A special war tax of one half real was likewise collected.

Another form of tribute and manifestation of vassalage to Spain was forced labor known as polo. All Filipinos, from 16 to 60 years of age, excluding females, rendered forced labor for 40 days a year, building and repairing roads, bridges and churches, and other public works; cutting timber in the forests, and working in artillery foundries and shipyards.

Aside from tributes and forced labor as tokens of vassalage to Spain, the Spaniards also imposed a network of taxes as revenue sources for their survival and benefit. Tariff duties were collected which consisted of specific duties on all imports, surtaxes of harbor improvements, ad valorem taxes on imports, export duties and other miscellaneous charges. Several taxes were introduced to add to the internal revenue taxes, like the industrial and the urban taxes and the cedula personales.

The tributes and the taxes, plus the encomienda system which was also introduced by the Spaniards, became the sources of Spanish abuses and corruption.

Military Government During the American Period[5]

When the United States took possession of the Philippine Islands on August 13, 1898, the established military government had only limited supervision over matters of public finance. The collection of customs duties in accordance with the Spanish Tariff of 1891 continued, only with some changes.

Finance of the Philippine Republic[6]

On January 23, 1899, the Constitution of the Philippine Republic was proclaimed in Malolos with Emilio Aguinaldo as the President. The government of this Republic was supported by income from two principal sources of revenue: taxes and license fees, and military contributions, or war taxes.

Local taxes established during the Spanish regime was enforced and collected with the exception of the tax imposed on gambling and cockfights "which are prohibited, for they only tend to ruin the towns with little advantage to the public treasury." Men, eighteen years of age, who served neither in the revolutionary military nor in the police force, paid cedula tax at the rate of one peseta every three months. The cedula certificate was later substituted by the certificate of citizenship on the basis of capital the taxpayer possessed. For every civil suit in which the sum involved was not mentioned or did not exceed P500.00, a fee of P5.00 was charged; if the amount involved exceeded P500.00, the charge was one percent of that amount. Fees were also collected for the registry of births, deaths and marriage contracts. Taxes were also imposed on goods, transported either by rail or by boat, within the territory of the Republic, and also on articles for exports from localities within its jurisdiction.

In February 1899, the boards of defense and aid were created for the collection of taxes. Special payment in kind such as rice, edibles, etc., for the sustenance of the army was permitted. The Red Cross, headed by the wife of President Emilio Aguinaldo, and philanthropic societies composed of women who had been successful in making collections, were organized. Every municipality prepared its yearly budget with the approval of the supervising officials, and excess sums were remitted to the Provincial Government. The provincial government also prepared its budget, and if there was any surplus, it was sent to the Central Government. The central government budget for 1899 was $6,324,353.38 with $354,380.00 allotted to Finance.

The Civil Commission[7]

The reorganization of the system of handling government finance began when the Civil commission headed by William Howard Taft came into being. In accordance with the instructions of the President of the United States, the legislative power of the Philippine Government was transferred from the military to the Civil Commission on September 1, 1900. The military government was entirely superseded by a civil government on July 4, 1901 with the appointment of Taft as Civil Governor.

On September 6, 1901, the Philippine Civil Commission passed an act providing for the organization of the Department of the Interior, Commerce and Police, Finance and Justice, and Public Instruction. The Department of Finance and Justice had within its administrative control the Bureau of the Insular Treasury, the Bureau of the Insular Auditor, the Bureau of Customs and Immigration, the Bureau of Internal Revenue. the Insular Cold Storage and Ice Plant, the Bureau of Banks, Banking, Coinage and Currency, and the Bureau of Justice.

With the passage of Act No. 1407 of the Commission on October 26, 1905, the number of bureaus of the Insular Government wac reduced by abolishing some of them and consolidating others with those which were retained. Under this Act, only the Bureau of Justice, the Bureau of Customs, the Bureau of Internal Revenue, and the Bureau of Insular Treasury remained under the Department of Finance and Justice; but added to its jurisdiction was the finance of the City of Manila, as well as the supervising of banks and banking systems, coinage and currency.

During the period 1900 to 1905, the local governments were provided with their own sources of income among which was the real property tax which took some innovations. A monetary system of inspection and examination of banking institutions, an accounting and audit system, an internal revenue system and a Tariff Act of 1909, were established. The powers and duties of the Secretary of Finance and Justice were dual in nature and included matters which were not only purely administrative but also legislative in character. This state of affairs was due to the fact that the Secretary then was holding two positions: that of a member of the legislative body and that of an administrative official.

The Act of Congress of August 29, 1916, declaring the "purpose of the people of the United States as to the future of political status of the people of the Philippine Islands and to provide for a more autonomous government for those Islands," created four executive departments.

Reorganization Act No. 26665[8]

On November 18, 1916, the Philippine Legislature passed the Reorganization Act No. 26665 which increased the number of executive departments from four to six. At the same time the Department of Finance and Justice was split into two separate departments. The departments thus created were the Department of Finance, the Department of Justice, the Department of Agriculture and Natural Resources and the Department of Commerce and Communications. The executive functions of the government were distributed among the above mentioned departments subject to the general supervision and control of the Governor-General.

In the year that followed, a budgetary system was introduced in the Philippines, under the Jones Law, which required the Governor-General to submit to the Philippine Legislature within ten days after the opening of its regular session, a budget of receipt and expenditures to be used as the basis of the annual appropriations bill for the national government. The budget was prepared by the Secretary of Finance based on the estimates of income and expenditures submitted to him by the department secretaries. The Governor-General and his cabinet approved the budget after which it was submitted to the Philippine Legislature.

On April 25, 1936, a major change was effected upon the creation of the Budget Commission under Executive Order No. 25. The power and function of the Secretary of Finance related to the formulation of the Budget of the National Government was transferred to the Commission, although the preparation of income estimates remained with the Department of Finance until 1955 with the passage of P.A. No. 992.

The Japanese Occupation

On January 3, 1942, after the Japanese conquered Manila, Lt. Gen. Homuna, Commander-in-Chief of the Japanese Military forces in the Philippines, proclaimed the establishment of the Japanese Military Administration for the purpose of 'supervising the political, economic and cultural affairs of the conquered land.[9] Subsequently, on October 14, 1943, the Japanese sponsored Republic was proclaimed, with Jose P. Laurel as President. Economic activities during the Occupation were limited, as industry, commerce and trade suffered a setback. There was practically no production and agricultural lands remained idle for a time, which caused the exorbitant price of basic commodities, particularly rice. Most people engaged in the buy- and-sell business. It was a common experience to see people exchanging almost anything just for a sack of rice or flour. Obviously, the Japanese encouraged the buy-and-sell business. They manufactured Japanese paper money with unreadable scribbling on it, which became popularly known as "Mickey Mouse" money. This "Mickey Mouse" money flooded the archipelago. The result was money inflation with everything sold at an astronomical price. To buy a few grants of rice, for example, one must have a bayong or small sack full of "Mickey Mouse" money.[10] A box of ordinary matches cost more than a hundred "Mickey Mouse" pesos, and so did cigarettes, coffee, tea and other basic commodities. Japanese authorities imposed luxury taxes and license fees and printed Japanese war notes during the three years of occupation. The National Assembly of the Japanese sponsored Philippine Republic authorized the creation of a Central Bank which did not actually come into being. On September 2, 1945, the Japanese signed its surrender to the United States and the Occupation finally ended.

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CHAPTER 3

DEVELOPMENT FINANCE

I. INTRODUCTION: THE CHANGING MEANINGS OF DEVELOPMENT

II. TOWARDS SUSTAINABLE DEVELOPMENT

- A. Concept of Sustainable Development
- B. Measuring Development : The Human Development Index

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DEVELOPMENT FINANCE

I. INTRODUCTION:

THE CHANGING MEANINGS OF DEVELOPMENT

In most developing countries, "development" is one of the most abused words. Like Madame Roland's Liberty, many crimes are committed in its name. When a massive monument is built, it is infrastructures for development; when a giddy festival is launched, it is for social development; when deficits mount, these are for development; when inflation gallops, these are indications of development; when corruption rages unchecked and uncontrolled, it is part of the development process. Indeed, like the phrase "general welfare," everything and anything can be subsumed under it.

Ever since the developing countries were taught by their western tutors that they have to attain "development" in order to be self-respecting members of the international community, they have latched on to the word and used it to justify all sorts of activities. The fact that the meanings and interpretations of the word have been changing since the 50's has given the policy-maker and politician a wide array of meanings to choose from, depending upon his intentions and aspirations for immortality and greatness.

Thus, no public document is complete without this all important word, no public speech or book is acceptable without it, no project is launched without a tribute to it. When the word "development" is attached to the name of an agency, a corporation or a project, somehow the organization seems imbued with nothing but the noblest of intentions. In the Philippines for example, we have a large assortment of agencies with the word "development" inserted somewhere. This is true especially in the names of public corporations. It is therefore very easy for "development" to become the excuse and not the objective.

In a review of leading theories of economic development during the past forty years, Michael Todaro identifies four major approaches: (1) linear stages of growth model, (2) theories and patterns of structural changes, (3) the international dependence revolution, and (4) the neoclassical, free market counter-revolution.[1]

The first group of theorists looked at economic development as a series of stages through which all countries undergo, given the right mix of saving, investment and foreign aid. Developing countries at that time were taught

that development was merely a matter of time, and that they would fc the same historical path trod by the industrialized nations.

W.W. Rostow and his "Stages of Economic Growth" theory and Harrod and Evesey Domar with their Harrod-Domar Growth Model typif linear growth theories of the 50's and 60's. Rostow wrote that all soci go through five stages: the traditional society, the pre-condition for tak into self-sustaining growth, self-sustaining growth, the drive to maturity, the age of high mass consumption.

The Harrod-Domar growth model states that the rate of growth o GNP is determined jointly by the national savings ratio and the nati output ratio. Thus, in order to grow, economies must save and inve certain proportion of their GNP. The more they can save and, theref invest, the faster they can grow.

During the seventies, structural change models dominated econc development theory. The latter describes the mechanism by which un developed economies transform themselves from traditional subsiste agriculture to industrialization. Todaro cites W. Arthur Lewis and H Chenery as representative proponents of this theory.

The Lewis model described underdeveloped economies as having sectors: (1) the traditional, overpopulated, rural subsistence sector anc a high-productivity modern urban industrial sector into which labor from subsistence sector is gradually transferred in the process of growth.

Using empirical comparisons of the development of different count as basis, Chenery concludes that development is an identifiable proces growth and change whose main features are similar in all countries.

On the other hand, the structural-internationalists examine the phen enon of the underdevelopment in terms of international and domestic po relationships, institutional and structural economic, rigidities, and the res ing proliferation of dual economies and dual societies. Focus is placec the need to eradicate poverty to provide diversified employment opport ties, and to reduce income inequalities.

Todaro describes the international-structuralists models as indi outgrowth of Marxist thought which attributes underdevelopment "to historical evolution of a highly unequal international capitalist syster rich-country-poor country relationships. Whether internationally exploita or unintentionally neglectful, the coexistence of rich and poor nations in international system dominated by such unequal power relationships tween the center and the periphery renders attempts by the poor socie

(the periphery) to be self-reliant and independent in their development efforts difficult and sometimes even impossible."[2]

Under the above theories, underdevelopment is seen primarily as an externally induced phenomenon as opposed to the linear stages and structural change theories which stress internal constraints.

The last group of theories is described by Todaro as part of the neoclassical counter-revolution which dominated the '80s. This was brought about by the "political ascendancy of the conservative governments in the United States, Canada, Britain and West Germany." Focus was on supply side macroeconomics and the privatization of public corporations, and the call for the dismantling of public ownership, planning and regulation of economic activities. As summarized by Todaro, the central argument of the neoclassical counter-revolution is that underdevelopment results from poor resource allocation due to incorrect pricing policies and too much state intervention.

During the past thirty years, the concept of development has changed from exclusive concern with economic development to include social and political development as well. Where before development was measured in terms of growth of GNP, other measures looking into redistribution of income and wealth, the poverty line, effectiveness of government services delivery, and individual well-being were developed.

Taking into consideration the various strands of thought on the concept of development, it is now "conceived as a multidimensional process involving major changes in social structures, popular attitudes, and national institutions, as well as the acceleration of economic growth the reduction of inequality and the eradication of absolute poverty. Development in its essence must represent the entire gamut of change by which an entire social system, tuned to the diverse basic needs and desires of individuals and social groups within that system, moves away from a condition of life widely perceived as unsatisfactory and toward a situation or condition of life regarded as materially and spiritually 'better.' Furthermore, three core values of development are described: Life-sustenance - the ability to provide basic needs; self-esteem - to be a person; and freedom from servitude - to be able to choose.

Three objectives of development are identified:

1. To increase the availability and widen the distribution of basic life-sustaining goods such as food, shelter, health and protection;

2. To raise levels of living including, in addition to higher incomes, the provision of more jobs, better education and greater attention to cultural and humanistic values, all of which will serve not only to enhance material well-being but also to generate greater individual and national self-esteem;

3. To expand the range of economic and social choice to individuals and nations by freeing from them servitude and dependence, not only in relation to other people and nation- states, but also to the forces of ignorance and human misery.[3]

The above concept of development which is a distillation of the thoughts of concerned and committed scholars, is so beautiful and moving that many developing countries have adopted its ideas enthusiastically, in varying degrees. The above concepts are reflected in their national development plans, budgets and policy pronouncements.

II. TOWARD SUSTAINABLE DEVELOPMENT

A. *The Concept of Sustainable Development*

In the preceding section, theories of economic development which influenced policies of developing country governments for forty years were summarized. The concept of development, which has changed over the years for likewise amplified.

The decade of the eighties saw the emergence of the concept of sustainable development. Increasing concerns about the state of environmental destruction of Planet Earth, the lingering global debt crisis and the escalation of poverty in both rich and poor countries impelled scholars, and distinguished national and international leaders to rethink concepts of development and search for new approaches to global problems.

The World Commission on Environment and Development (WCED) which was created by the United Nations General Assembly to formulate a global agenda for change, described sustainable development as,

> *"not a fixed state of harmony, but rather a process of change in which the exploitation of resources, the direction of investments the orientation of technological development, and institutonal change are made consistent with future as well as present needs."*

Development must meet the needs of the present without compromising the ability of future generations to meet their own needs. As WCED points out, "the concepts of sustainable development does imply limits--not absolute limits but limitations imposed by the present state of technology and social organization on environmental resources and by the ability of the biosphere to absorb the effects of human activities."

Clearly, sustainable development is not all about preserving the environment as an end in itself. Sustainable development implies a new concept of economic growth--"one that provides fairness and opportunity for all the world's people, not just the privileged few, without further destroying the world's finite natural resources and carrying capacity."

The catastrophic experiences of the decades of the seventies and the eighties have dramatically shown that the obsessive pursuit of development, industrialization and material wealth, with rich countries as models and teachers, has resulted in the wanton waste and exploitation of natural and human resources. It has seen not the elimination, but the exacerbation of poverty. The pursuit of "development" has not brought liberation but even greater suffering for mankind. The lesson that the past two decades has taught mankind is that sustainable development is not just a goal for developing countries. It is a global concern requiring joint efforts from rich and poor countries. In the words of the WCED, all must work together for "our common future."

Jan Pronk and Mahbubul Hag integrated emerging concepts of sustainable development thus:

"The call for sustainable development is not simply a call for environmental protection. Instead, sustainable development implies a new concept of economic growth--one that provides fairness and opportunity for all the world's people, not just the privileged few, without further destroying the world's finite natural resources and carrying capacity.

Sustainable development is a process in which economic, fiscal, trade, energy, agricultural, industrial and all other policies are so designed as to bring about development that is economically, socially and ecologically sustainable. This means that current consumption cannot be financed for long by incurring economic debts that others must pay. This also means that sufficient investment must be made in the education and health of today's population so as not to create a social debt for future generations. And natural resources must be used in ways that do not create ecological debt by overexploiting the carrying and productive capacity of

the earth. All postponed debts mortgaged sustainability--whether economic debts or social debts or ecological debts."

The call for sustainable development has resulted in the creation of the United Nations Commission on Environment and Development (UNCED). The latter spearheaded the Earth Summit in Brazil in June 1992, wherein governments formulated treaties to ensure the safety and survival of Planet Earth, and to create a framework for development which is politically, socially and ecologically sustainable.

B. *Measuring Development: The Human Development Index*

The eighties which brought dramatic changes in concepts of development likewise saw the orthodox methods of measuring development challenged as well. The GNP has long been criticized as an incomplete or insufficient indicator of development. Because of the emphasis on economic growth, people are largely left out. It has been shown time and again that economic growth may not necessarily bring about a better quality of life for people. Income redistribution and reduction of poverty may not follow in the wake of economic growth.

Even as the clamor for sustainable development rose during the eighties, the need for more meaningful measures of development became equally urgent. In 1990, the United Nations Development Programme (UNDP) came out with its first Human Development Report. This was followed by the 1991 and 1992 reports.

Instead of the usual economic indicators the Report focussed on indicators of human development on a global scale. A new measure for socio-economic progress was designed: the human development index (HDI). The HDI integrated life expectancy, adult literacy and income in an innovative way, resulting in a yardstick more comprehensive than the GNP.

C. *Implications for Fiscal Policy*

The concept for sustainable development has wide-ranging implications for fiscal policy and the traditional priorities associated with it. Since it calls for a shift towards fiscal policy which will finance sustainable development, change in revenue resources and priorities in expenditures are called for.

The call is to desist from revenue sources which will deplete and destroy the environment and to give priority to expenditures towards the healing and nurturing of the environment, as well as to the needs of the people. At the same time, the requirements for the survival of future generations must not be compromised.

Thus, developing countries are discouraged from wantonly destroying their forest, mineral and aquatic resources in order to raise revenue. The link between environmental degradation, debt and poverty are now increasingly recognized. The call is to give priority to people and nature over and above the payment of unjust debts, especially those tainted with fraud.

The Earth Summit in Rio initiated by the United Nations Commission On Environment and Development in June 1992, did not cover agreements on environment alone. Fiscal issues were vigorously debated. A debt treaty was proposed calling for substantial reduction in the debt of developing countries.

Implementing development likewise requires massive funding and reordering of fiscal priorities. Unproductive resources have to be freed and made available for human development programs and projects. Advocates of human development have also called for action on the global debt problem.

Clearly, emerging concept of development imply corresponding changes in development finance.

III. FINANCING DEVELOPMENT

In order to translate development objectives into reality, financing is, of course, needed. In harmony with other measures, fiscal policies are expected to generate resources in order to finance developmental activities. These activities in turn are projected to have effects not only on the economy but on the socio-political system and on individuals as well.

It has been pointed out that the concepts of development have been changing from the purely economic perspective to a multidimensional perspective. Development programs of LDC's reflect these changing concepts. However, whatever the interpretation of development is, the fact remains that development is a very expensive commodity. It is way beyond the capabilities of the developing countries to finance their own. This is one basic reality that developing countries have to contend with. Many developing countries have been dashed against the rocky shores of bankruptcy; many political leaders have lost their power, or worse still, their heads, in the course of the search for the elusive "development."

Books on economic development always list the common characteristics of poor countries. More often than not, they have practically nothing in terms of financial resources to start with. Whatever resources they generate are barely enough to maintain their bureaucracies; very little is left over for

development projects. At the same time, the economists surge them to raise their GNPs; the political scientists warn them to overhaul their political institutions; and other social scientists nag them about their being poor. All the while, their people are treated to a barrage of irresistible propaganda from the west which whet consumer appetites. Finally, they are assured of loans to finance their projects.

To finance their development aspirations, developing countries have resorted to several strategies: taxation, non-tax revenues, bilateral and multilateral assistance, contributions from international NGOs, and borrowing.

During the late sixties, the seventies, and on to the early eighties, developing countries relied primarily on external borrowing to finance their programs. They were under tremendous pressure to put up the necessary infrastructure in preparation for the take-off to development. Since revenues from taxation and other sources were not sufficient, external borrowing became the order of the day. Thus, the word "development finance" became identified with external borrowing.

In August 1982, the global debt bomb was detonated with the balance of payments crisis of Mexico. The crisis lingered on to the nineties. More than anything, it has shattered the myth that development can be financed and attained almost exclusively by massive borrowing. It has triggered efforts to formulate alternative strategies for financing development.

In the light of the built-in incapabilities of developing countries to finance their development programs, they have been getting a lot of advice and assistance. This activity is more popularly known as "development finance".

A. *The Role of Fiscal Policy*

Scholars rightly give a great deal of importance to the role of fiscal policy in development finance. It is generally agreed that developing countries have to work out the proper mix of tax, expenditures and borrowing policies not only to finance development programs but also to obtain certain effects on the economy. Fiscal policy has traditionally been assigned three major functions: the allocation function, the distribution function and the stabilization function.

As explained by Musgrave and Musgrave [4]

1. The provision for social goods, or the process by which total resource use is divided between private and social goods and by

which the mix of social goods is chosen,may be termed as the allocation function of budget policy. Regulatory policies, which may also be considered a part of the allocation function, are not included here because they are not primarily a problem of budget policy.

2. Adjustment of distribution of income and wealth to assure conformance with what society considers a "fair" or "just" state of distribution, is referred to as the distribution function.

3. The use of budget policy as a means of maintaining high employment, a reasonable degree of price level stability, and an appropriate rate of economic growth is termed the stabilization function. There is also the object ive of stability in the balance of payments.

We must, however add a most important function of fiscal policy in developing countries: the development function. When we add the development component to the traditional functions of fiscal policy, the entire picture changes.

In the performance of the allocation function, budgetary policy is expected to regulate the balance between private goods and social goods. The benefits of social goods are available to all members of society. In other words, social goods are for all. On the other hand, private goods are not available to everyone, once they are sold. For example, once a pair of shoes is brought by a customer, it is not available to others. Yet a person can walk on a public road and not deprive others of the benefit of walking on that same road. The "exclusion principle" works in the case of private goods. Consumers are excluded unless they pay.

Normally, private goods are produced by the private sector. Social goods are produced by the public sector. In developing countries however, the state may end up producing both private goods and social goods as well. Private goods can be sold at subsidized prices by state enterprises. In an industrialized capitalist society, there might be more private goods than social goods. However, because private goods may not be available or are too expensive in developing countries, they are produced and distributed by the state and made available to all.

Thus, what might be considered private goods in advanced countries can be social goods in a developing country. "Normal" private goods like food, housing, medicine and even higher education can be considered public goods in a developing country. Therefore, the allocation of private goods and social goods might be the exact opposite of what happens in an industrialized country. The implications on budgetary policy are of course,

tremendous. Allocations must be made for the production and distribution of more social goods.

In other words, the classification of social goods and private goods may be very different in developing countries. Furthermore, more social goods will have to be produced. This will impose a heavy burden on the LDC budget.

The second function which is redistribution of income and wealth is a much more serious problem in developing countries than in industrialized countries. The gaps between the rich and poor are in some cases, insurmountable. This issue is not only an economic problem but a political powder keg as well. Fiscal policy has the difficult burden of bridging the yawning gaps between the rich and poor. Such a function, again, might have serious implications for tax and expenditure policies.

The third function, stabilization, is perhaps the most difficult to attain in developing countries. Rare is a developing country which is not plagued with chronic BOP problems, inflation, unemployment and the like. When the stabilization function is ranged against the development function, the former becomes practically an impossibility. For a developing country, the development function of fiscal policy can have a destabilizing effect. The insatiable demands of development will entail massive expenditures, heavy importations and infrastructures. Inflation almost always follows in the wake of aggressive development activities. It also entails heavy drain on foreign exchange.

The concept of fiscal policy was originally developed as a tool for stabilizing economies in crisis. It was then exported to developing countries and prescribed as a tool for financing development. The experience of developing countries during the seventies is most instructive. Development was equated with massive insfrastructures, large scale projects and elaborate programs. Massive financing was required.

An orgy of borrowing ensued--all in the name of development. The vulnerable economies of developing countries were exposed to the instabilities of the international environment and the debt crisis was triggered in 1982, leading to the "lost decade" of the eighties. The global debt crisis has lingered on till the decade of the nineties.

The experiences of many developing countries during the sixties and the seventies has underlined the need to balance the drive for development with the need to maintain stability. The decade of the eighties, and now of the nineties, has shattered the assumption during the seventies that a country can aggressively push for development financed from borrowing, and attain economic stability at the same time.

B. *Current Strategies in Development Finance*

1. **The Role of Taxation** - Available literature in public finance place a great deal of importance on the role of taxation in development.[6] It appears that this is the main instrument which is relied upon for revenue generation. Thus, developing countries have been getting a great deal of advice on the proper mix of tax policies. Such advise notwithstanding, developing countries appear not to be able to generate enough revenue from taxes, as indicated in their tax effort.

The case of the Philippines is illustrative. Revenue from taxation rose from P1,083 million in 1960 to P163,321 million in 1990. While the level of tax revenue has been increasing in absolute terms, the share of the tax revenue in relation to the total revenues of government has been declining. From 1960-1964, taxes accounted for 73% of total revenue. From 1965 to 1971, this declined to 67%. From 1972 to 1980, the share of taxes out of total revenue went further down to 55%. From 1981 to 1985, this went slightly up to 58%. During the Aquino years, the share of tax revenue went down again to 56% (See Chapter 7, Figure 5). Inspite of efforts to emphasize the primacy of tax revenue as a source of financing for development, its share of total revenue has been declining instead.

Despite increases in the level of tax revenue, these have not been enough to cope with escalating levels of government expenditures.

Why can't tax collection cope with development expenditures? For one thing, the tax base in developing countries is small, compared to industrialized countries. Economic rigidities inhibit flexibility and buoyancy in important taxes. During the Marcos administration, the government declared a series of tax amnesties to capture uncollected taxes but obviously, there is a limit even to the bonanzas from tax amnesties.

For another, tax collection is not only an economic issue, it is also a behavioral issue since it is generally associated with corruption. Finally, developing countries do not really have as long a tradition as the industrialized countries in tax collection. As pointed out in Chapter 2, many modern taxes actually have been very ancient origins in Europe. Organized and complex systems of taxation were widespread during the feudal period in that region. A number of "modern" taxes can even be traced further back to the days of the Roman Republic.

On the other hand, taxation in developing countries is closely linked with colonial history. Developing countries association with taxes is hardly developmental. The idea of taxes contributing to national development is fairly new since most developing countries regained their independence only after World War II. In the Philippines, for example, forty-seven years of national

taxation is not really much, compared to over 400 years of tributes and taxes forcibly imposed by various colonial masters. In other words, tax consciousness is not deeply ingrained in developing countries as it is in the industrialized countries.

2. **Non-tax Revenue** - Revenue generated from sources other than taxes and borrowings, appear not to be given much importance, whether by academicians, advisers or policymakers. Available literature concentrate almost exclusively on taxation.

In the Philippines, from 1972-1980, taxes and borrowing accounted for nearly 90% of total revenues. Non-tax revenue were very minimal. The situation from 1980 -1990 is pretty much the same.

Non-tax revenues include capital revenue and extraordinary income. Capital revenue refers to revenue derived from the sale of assets. Extraordinary income includes income from government agencies like government owned or controlled corporations (GOCCs) which are required by law to pay dividends on their income. Unfortunately, the history of national government relations with GOCCs is one of dependency and not of contribution to national government revenue.

During the Marcos administration, policymaker hit upon the idea of increasing revenues by creating a gambling corporation. The Philippine Amusements and Gaming Corporation (PAGCOR) was originally created as a joint venture between the government and its managing partners. Sharing of income was on a fifty-fifty basis. Social welfare programs of the Office of the President and the activities of the First Lady were financed from PAGCOR operations. While the government and its partners earned substantial revenue from PAGCOR, accountability problems developed. The Commission on Audit complained that it could not audit PAGCOR accounts properly since it had to access to the latter's financial records.

When the Aquino administration took over, PAGCOR was reorganized into a wholly owned government corporation. A new management team took over. At present, PAGCOR is cited as the third largest revenue earner in the government. A portion of its income goes directly to the Office of the President for social welfare projects. While revenues have increased tremendously, reservations about the government directly managing gambling casinos linger.

The administration of President Fidel V. Ramos continues operating PAGCOR.

As of this writing, there are plans to legalize other forms of gambling, particularly jueteng, in order to raise more revenue.

Revenues from casino operations appear to be a rich source of non-tax revenue. No less than two administrations depended on gambling for additional revenue. The present administration displays no inclination to privatize PAGCOR inspite of its aggressive privatization policy.

Nevertheless, it must be pointed out that the values promoted by direct government involvement in gambling may not complement development values which the government also seeks to encourage. These are the habits of productivity, thriftiness, saving, and hard work, among others. The issues surrounding direct government involvement in the management of gambling casinos are complex and not necessarily limited to the generation of non-tax revenue.

There are other opportunities for increasing non-tax revenues. GOCCs can be compelled to pay dividends to the national government, as required by law. They can be encouraged to increase levels of effeciency and productivity. Regular government agencies which earn revenue can also be required to report their incomes accurately,as well as increase productivity. A comprehensive review can be made of the existing sources of non-tax revenue to determine ways of generating more income for the government.

3. **Grants from multilateral and bilateral partners**- Contributions from international institutions and other countries constitute a substancial portion of government revenue.

Multilateral institutions like the World Bank and Asian Development Bank give grants in addition to loan packages. Governments of industrialized countries like Japan and the United States also give outright grants aside from loans. However, these grants are usually accompanied by conditionalities.

Grants are usually given as part of official development assistance (ODA by multilaterals and bilaterals. Recently, ODA has gained much importance, especially during the Aquino administration. Leading bilateral partners like the United States, Japan, and Europian countries agreed to put up the Philippine Assistance Program (PAP) and increase levels of assistance to the Philippines. Such assistance includes outright grants to the government.

It must be pointed out, however, that multilateral and bilateral grants are not necessarily given out in cash. These usually take the form of equipment, expert technical assistance and training.

4. **Borrowings** - Since the fifties, borrowing has served as the core of development finance. This was particularly true during the sixties and the seventies when borrowing for development reached unprecedented and uncontrolled levels. If there is one word which

characterizes development finance, it is borrowing. As a matter of fact, one even suspects that the two have become synonymous.

It is ironical that while textbooks on economic development continually focus their attention on taxation, developing countries were going more and more into borrowing to finance their developmental ambitions. For example the external debt of the Philippines rose from US$.9 billion in 1972, and US$1.0 billion in 1973, US$3.18 billion in 1976 and reached US$8.588 billion in 1980.[8] By 1983, external debt levels had reached US$16B. By the end of 1991, it had reached the staggering level of $30 billion.

The detonation of the global debt crisis in 1982 shattered the illusion that development can be financed by accelerated external borrowing. The announcement by Mexico that it could no longer finance its balance of payments deficits triggered the crisis. Other countries followed in quick succession, including the Philippines which announced its bankruptcy in September 1983.

The debt crisis lingers on even during the decade of the nineties. In the Philippines, it remains as the most serious stumbling block to economic recovery and constitutes a major drain on the resources of the government and the economy. The crisis notwithstanding, developing countries still desperately look to external borrowing to raise much needed funds for development.

Why is it that developing countries seem to prefer borrowing to raising taxes and generating non-tax revenue? Is it because as one administrator puts it, borrowing is so much easier than raising taxes? There might be some truth to this statement during the sixties and seventies. For highly endebted countries however, borrowing during the decades of the eighties and the nineties has become a nigthmare filled with the horrors of increasing interest rates, and crushing conditionalities. Nevertheless, they persist in their begging missions for more loans.

Is it because the costs of development are such that tax revenue is never and can never be enough? Whatever its definition--economic development, social development and now sustainable human development is very expensive. No developing country can finance development from its own revenues.

Or is it because the international financial system draws developing countries inexorably to borrowing?

Borrowing plays a central role in traditional development finance. As a matter of fact, it is built in the concept of development finance itself. It is easy to understand why this should be so. Firstly, development programs are very

expensive, as interpreted by developing countries. Whether the focus is on economic development with its demands for infrastructure spending and foreign exchange, or social development with its equally expensive programs in health, education, and culture, the fact is development expenses can easily escalate beyond manageable levels.

In the second place, tax revenues are not adequate, as pointed out earlier. Finance officials huff and puff themselves to exhaustion. They raise tax levels twofold, threefold and even sixfold. And yet, like Alice in wonderland, they have to keep running just to be able to stay in place. In the third place, accepted fiscal policy theory recognizes the necessity of borrowing in order to attain economic objectives. In the Philippines, prior to 1972, writings on public fiscal administration devoutly upheld the theory of the balanced budget even as the country was running up deficits. After 1972 when the Philippines launched its massive development programs, a clear fiscal policy shift was announced. The necessity of deficit- spending was explained in many policy statements. No less than President Marcos himself discussed this issue on several occasions. Finally, the international environment - advisers, international financing institutions, and industrialized countries - all encourage borrowing.

IV. EMERGING CONCEPTS IN FINANCING SUSTAINABLE, HUMAN DEVELOPMENT

In the preceding section, traditional sources for financing development were identified. However, the global debt crisis of the eighties and wide-ranging changes in concepts of development have exposed the inadequacies of these sources and emphasized the need to identify new sources for financing sustainable human development.

The experience of the decade of the eighties has taught developing countries that the tool of borrowing, if wielded irresponsibly can trigger more harm than good. It is generally recognized that the emerging concept of sustainable human development will require massive resources on a national and international scale. Hence, the need for more sources of financing.

V. ISSUES AND PROBLEMS

A. *What Price Development?*

It has been repeatedly mentioned that development tends to be expensive. In the process of implementing development plans, massive resources are poured into an LDC, resulting in frenzied activity. In the Philippines, for example, from 1972 - 80 over P240 billion was spent by the national and local governments (See Chapter 14 on Patterns of Expenditure). Can an

LDC take massive doses of resources and spending in stride? It seems spending begets spending. Even when there is very little to spend and few projects to spend on, problems like overpricing, waste and efficiency persist. When expenditures escalate, it appears wastage also escalates. Inflation creeps in and gallops away. For example, the 1977 COA Annual Report noted that "the average percent ratio of the increase in the actual cost of construction project over the original contract amount is 34%. Since the established maximum allowable for cost increases is 25% several road projects, change and/or extra work orders which number in some instances to as many as 8 or 9 contacts have therefore risen by as much as 27% over and above the original contract amount."[9] When you translate 34% into highways contracts involving millions of pesos, the actual escalation costs are terrifying. Considering that the building of highways and roads is a major effort in the infrastructure program, cost escalations would therefore be of considerable magnitude.

On the other hand, the Performance Audit Office of the Commission on Audit reported in 1980 over P305 million in adverse findings ranging from the purchase of P156 million worth of medicines unfit for human consumption to short levies from coconut end users amounting to P95 million. Since the PAO is one of six major offices in the COA engaged in audit activities, one dreads to find out what the findings of the other offices are! By 1982, PAO had reported over P700 million in doubtful recovery ranging from matured money market placements of doubtful recovery amounting to P289 million to unliquidated cash advances of P73 million.[10]

As of 1980 the Commission on Audit counted 169 government corporations, excluding hundred of subsidiaries. COA auditors rendered adverse opinions on the financial statements of 100 of these corporations. Total assets from these corporations exceed P249 billion.[11] This seems to indicate that more often than not, one can find problems ranging from unrecorded inventories, uncollected money market placements, accounts receivable of doubtful collectibility, etc. and other matters which have heavy cost implications.

It appears from the above that development also brings tremendous wastage and overpricing in its wake. This makes development oven more expensive and exacerbates inflationary tendencies which are always present in developing countries. Not all development expenses really end up as additions to productive output; however, these are added to development costs. Can development be too expensive and too fast?

What I am trying to say is that the pace of development as urged by advisers and implemented by national leaders might be too much for an LDC to absorb. I have only touched on the cost implications which impinge on

development finance. The social and political implications of change, planned or otherwise, are even more grave.

When so much resources are poured into an LDC where waste, inefficiency and corruption are facts of life, it does not mean that more output is produced; the rate of corruption and inefficiency merely goes up. Even in an LDC where inefficiency and corruption may not necessarily be a way of life, sudden "wealth", even if borrowed can be very heady. It will take the highest level of discipline on the part of national leaders and administrators to resist the urge to splurge on development, especially if money can be borrowed.

I repeat, development by itself is expensive. It involves a process by which developing countries try to attain during the lifetime of a political leader what took industrialized countries centuries to evolve and develop. When all the add on costs are added, then development expenses become truly staggering and unmanageable.

Is it worth it? Economists and other social scientists are still trying to find answers. Todaro reformulates Dudley Seers' questions, thus:[12]

1. Have general levels of living changed within a nation to the extent that absolute poverty (i.e., deprivation of life-sustaining goods); the degree of inequality in income distribution; the level of employment; and nature and quality of educational, health and other social and cultural services improved?

2. Has economic progress enhanced individual and group esteem both internally vis-a-vis one another and externally vis-a-vis other nations and regions?

3. Finally, has economic progress expanded the range of human choice and freed people from external dependence and internal servitude to other men and institutions, or has it merely substituted one form of dependence (e.g. economic) for another (e.g. cultural).

It appears that inspite of the orgy of development spending of developing countries, the above questions cannot be answered in the affirmative with conviction.

On the issue of development costs, perhaps two questions could be raised:

1. Are development costs too high? If so, can they not be reduced? Is it possible to remove the frills and furbe-lows of development and concentrate on the basics - for a start?

2. Are there less expensive options?

Well-meaning advisers from international agencies and lending institutions tend to impose their standards of comfort and luxury whenever projects are set up. Thus, when a nuclear plant is built, accommodations which even rival those of 5-star hotels are set up at the site with all conceivable luxuries which are normal in an industrialized country, but can be considered downright immoral in a poor one. These would include richly furnished rooms, tennis courts, helipads, etc. Of course, all these form part of the cost of the nuclear plant!

At the same time, developing countries in their eagerness to show that they are just as advanced and as cultured as the industrialized countries, try to match and even exceed amenities in the West. A theatre must surpass those of other countries in opulence and glitter. Never mind if borrowings have to be resorted to in order to set it up! A foreigner once commented about a grand theater in an LDC, "this is something no rich country can afford!" Government buildings must be as imposing as those of the West, complete with all the latest gadgetry and the most expensive furnishings and paintings. Conferences about the poor, the undernourished, the deprived, and the suffering must be held in the most luxurious hotels, and glamorous convention centers - the better to appreciate poverty with. Projects - be it a dam, a housing project, electricity, a house, a museum, or even a movie - have to be launched with all pomp and ceremony. Development must be accompanied by rituals - the more glamorous and publicity-laden the better. All these charming but expensive little touches jack up development costs. Can these be reduced?

Are there less expensive options? The Minister (now Secretary) of the Budget once remarked that there are more than twenty major agencies involved in the problem of malnutrition. Malnourished babies therefore have to undergo the discomforts of being weighed more than twenty times by different solicitous agencies. One wonders, however, if the process has increased their weight! We have many agencies working on similar problems. And of course all are asking for more budget money.

On the matter of foreign-financed projects, a feasibility study is a standard requirement by financing institutions. However, data requirements might be too detailed; procedures required might be too expensive and time consuming, resulting in costly delays. For example, the feasibility study for the Manila MUDP Project took more than three years to complete at a cost of P3.6 million. Consultants are among the biggest cost items in foreign

financed projects. While their value cannot be minimized, their costs can probably be reduced. The Philippines prides itself in its very high level education and expertise. While we probably need experts in the "hard" sciences like nuclear physics, must we get consultants on government management at the rate of $500 a day?

There is a tendency to have enormous development projects especially those which are foreign funded. This is probably because consultants are thinking in terms of their own countries. Can these not be scaled down in grandeur and expense? Is it necessary to have the biggest nuclear plant, the longest bridge, the largest dam, the grandest theater? Can development be attained even if gargantuan projects are reduced?

B. *Development and Stability - a Mirage?*

It has been pointed out earlier that when development is added to the traditional fiscal policy functions, stability takes a back seat. Mention has been made of the huge financial costs of development. Other related effects of escalated costs would have impacts on the economy like inflation, distribution of income, etc. But the most inroads are on balance of payments stability because of the enormous demand for foreign exchange.

Gigantic development projects are, more often than not, foreign financed. These involve heavy import requirements of human resources (consultants and contractors) material (machineries, raw materials) and technology. These projects in turn generate economic activities (industries) which require massive foreign exchange support.

These projects therefore have the effect of the doors of developing countries wider to international instabilities. The "exposed" economy which Heller talk about becomes even more exposed with gargantuan development projects. Development as currently interpreted, can have the effect of exacerbating the vulnerability of developing countries to international instability. Developing countries carry within themselves the seed of instability. Development activity aggravates it inexorably. When there are instabilities among the industrialized countries, such problems are automatically brought to the very core of LDC development efforts. As some officials put it, when the industrialized countries sneeze, the developing countries automatically have a fever.

BOP instabilities ignite other economic instabilities, In turn, these spark off political and social unrest. There is truly a need to further study the phenomenon of development. It is not enough to say what it should be or ought to be as prescribed in most textbooks. It is necessary that more objective studies be conducted on what is really happening to the development programs of developing countries. There is special need to look deeper

into the relationship between development and instability which often comes in its wake. Must one ignite the other? If this is so, then the way to development is interpreted both by LDC and their advisers should be reexamined in order to minimize its destabilizing effects.

One aspect that should be looked into is the role of the international environment. Admittedly, instabilities in the international environment affect the developing countries. And yet, the developing countries are depending more and more on outside resources for financing. This is clearly indicated in their increased borrowing activities. It appears that they are turning more and more to the very "resources" which also bring instability! A reexamination of development and instability would therefore require an examination of the role of the international environment.

Another aspect which even developing countries are aware of, but which is not often discussed is the fact that development as implemented is very good for the industrialized countries. Development is indeed very good for the international lending institutions who find eager borrowers for their funds and who readily accede to their financial and other conditions. It is very good for international contractors who capture contracts for infrastructures and management services, in billions of dollars. It is wonderful for their top level consultants whose earnings in developing countries go a much longer way than back home. It is very good for their industries which exports everything from dams to medicines. It is very good for their funds which goes back to them in the form of interest payments, consultants' fees, contractors' fees and payments for LDC imports. Yes, development is good for the industrialized countries. But has it been good for the developing countries?

C. *Non-Tax Revenue - a Neglected Resource*

It has been noted earlier that advisers and consultants of the developing countries concentrate mainly on the tax as a source for locally generated funds. This is where most of their expertise lies. One only has to take a cursory look at books on Public Finance to note the emphasis on taxation. and yet, developing countries are not getting enough from taxation, for various reasons. Tax experts rightly say that more taxes can be collected from a country like the Philippines. However, when tax collection efforts are taken within the context of tax traditions, administrative difficulties, structural rigidities and political complications, there are clear limits to the amount of taxes that can be collected. This is something even consultants of foreign financing institutions cannot understand. It is beyond them why all taxes cannot be collected.

Instead of banging heads on the tax wall, it might be useful to examine other options aside from tax revenue. In the Philippines, the resistance to taxes borders on hysteria. No amount of statistics and even threats from

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finance officials can convince taxpayers to pay more. And yet, when the government resorts to other strategies for revenue generation without calling such as taxes, these have been successful. Mention has been made earlier of the gambling casinos. Lotteries are very effective resource generators, even in industrialized countries. Last January 1983, the Philippines held its Manila International Film Festival and allowed the screening of films without the benefit of censorship. It is claimed that more than P49 million was raised in a matter of two weeks. However, these activities have not been without their unsavory side effects. It might be possible to work out revenue generation schemes which do not carry the stigma of controversy and moral debate. The compulsory system making employees from both the public and private sectors contribute to a housing fund (PAG-IBIG) has been spectacularly successful in mobilizing savings from millions of employees.

The public corporate sector is another potential source of non-tax revenue. In centrally planned economies, taxes account for only 8-10% of total state revenue, with state enterprises for a sizeable share. In the Philippines, more and more corporations are created to perform specific development functions. In 1980 however, the Corporate Audit Office of the Commission on Audit reported that twenty-nine government corporations suffered an aggregate loss of P445.77 million. Most of these were development corporations. Nevertheless, the overall net income of the corporate sector can be developed as a potential source of non-tax revenue. Its contributions to national revenue can be increased with greater efficiency of operations.

D. *Role of Borrowing*

It has been emphasized repeatedly that borrowing plays a central role in development due to inadequacy of local revenues, expensive development programs and the fact that fiscal policy theory recognizes the usefulness of the borrowing tool for economic goals. Developing countries are resorting to more and more borrowing, especially from foreign sources. In the light of the preceding discussions on development and instability, the following questions might be asked:

1. Borrowing is occupying an increasingly larger role in development finance. Should this be encouraged?

2. Should borrowing really be central to the theory of development finance? Or shouldn't it play only a supportive role?

The above questions are being asked because the performance of developing countries in handling their borrowing activities has been dismal, inspite of all the advice that went with the loans. A few years back, the cases of countries like Indonesia and Jamaica were repeatedly analyzed. Not long

ago, economists and bankers were nervously watching Latin America whose $300 billion foreign debt has largely been borrowed by only seven countries: Mexico, Brazil, Argentina, Venezuela, Colombia, Peru and Chile.[14]

Also, it has been pointed out that foreign borrowing as part of development finance opens the doors wider to international exposure and its instabilities. If this logic is pursued, then the goals of development might not be achieved because instabilities will always be skulking in the wake of accelerated borrowings.

The challenge therefore is to continue the role of borrowing in development finance, and searching for options and means of minimizing its destabilizing impact. A more detailed discussion on this issue is found in PART IV (Chapters 14-16).

IV. CONCLUSION

The preceding discussion has been an attempt to look into the financial aspects of development. All developing countries are for development. So are the industrialized countries. But there is a danger of falling in love with the word and not what it actually entails. Four issues have been raised: the financial costs of development, stability and the development process, potential for non-tax revenue and the role of borrowing.

ENDNOTES

[1]Michael Todaro, Economic Development in the Third World, (new York and London: Longman Press, 1981), pp. 56-85.

[2]*Ibid*, p. 2.

[3]*Ibid.*

[4]Richard A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and Practice (New York: McGraw-Hill Book Company, 1977), pp. 6-15.

[5]National Economic and Development Authority, Four Year Development Plan 1974-77, (Manila: NEDA Apo Press, 1974).

[6]Todaro, *op. cit.*, pp. 467-479.

[7]Agustin Kintanar, Jr., "Taxation Under Martial Law", UP-COA Professorial Chair Lecture delivered on April 6, 1983.

[8]*Ibid.*

[9]Commission on Audit, Annual Report 1977, (Quezon Cit: COA, 1977), p. 16.

[10]Commission on Audit, Annual Report 1980 and Annual Report 1982, (Quezon City: COA, 1980 and 1982), p. 18 and pp. 20-21 respectively.

[11]Commission on Audit, Summary Financial Report of Government Owned or Controlled Corporations, (Quezon City, COA, 1980).

[12]Todaro, *op. cit.*, p. 72.

[13]Commission on Audit, *op. cit.*, p. 13.

[14]Newsweek, "Another Latin Debt Crunch?", April 4, 1983, pp. 39- 40.

CHAPTER 4

THE CONSTITUTIONAL AND LEGAL BASIS OF PUBLIC FINANCE IN THE PHILIPPINES

I. INTRODUCTION: THE PHILIPPINE FISCAL FRAMEWORK

II. TAXATION

- A. Sources of Taxation
- B. Limitations on the Power of Taxation
- C. The Legal Process of Taxation

III. BUDGETING

- A. Nature of Budgeting
- B. Budget Formulation
- C. Constitutional Provisions
- D. Restrictions on Budgeting

IV. ACCOUNTING AND AUDITING

- A. Definitions
- B. Legal Framework

THE CONSTITUTIONAL AND LEGAL BASIS OF PUBLIC FINANCE IN THE PHILIPPINES

I. INTRODUCTION: THE PHILIPPINE FISCAL FRAMEWORK

The Philippine fiscal framework is embodied in the Constitution and the laws enacted by the legislative branch or the Congress which is composed of the Senate and the House of the Representatives. The legal and constitutional basis of each major component of Philippine public finance which includes taxation, budgeting, and accounting and auditing are discussed in this chapter.

II. TAXATION

As the most important revenue generating measure of the government, taxation has been aptly considered one of the three fundamental powers of the State (the other two being the police power and the power of eminent domain). The State needs the wherewithal to sustain its existence (to operate the government, to maintain an armed forces, etc.) and this justifies the exercise of the power to tax. Taxation is deemed bestowed to the State upon its creation. It is inherent in every State, it need not be expressly conferred by the Constitution. This may account for the silence of the Philippine Constitution on the grant of power to tax. The Constitution, however, grants local government units the power to tax since only the national government has the inherent power.

While taxation is inherent in the State, not every branch or office of the government exercises the power. It is "peculiarly and essentially legislative."[1] Since taxation necessarily interferes with the properties of taxpayers, it appears appropriate that the exercise of the power is entrusted to Congress - the branch of government which has the most number of directly elected representatives from among the taxpayers.

A. *Sources of Taxation*

The State power to tax, being essentially legislative, is expressed in the form of statutes. The tax system also includes the Constitution, administrative rules and regulations implementing the tax laws, administrative decisions interpreting tax laws and judicial decisions. These are briefly discussed below.

1. The Constitution is the fundamental law of the land to which all laws must conform. "It is the written instrument by which the fundamental powers

of government are established among the several departments for their safe and useful exercise and for the benefit of the body politic."[2]

The Constitution is also viewed as a covenant where the people surrender the exercise of some of their sovereign powers to the government. The Constitution limits and restricts the exercise of taxation by Congress.

2. Laws or statutes are congressional enactments, called Republic Acts (RA). These include Presidential Decrees (PD) promulgated by former President Ferdinand Marcos in the exercise of his lawmaking powers under the 1973 Constitution; the Batas Pambansa (BP) enacted by the defunct Batasan; and the Executive Orders issued by President Aquino pursuant to the Freedom Constitution.

The primary tax laws of the Philippines consist of the National Internal Revenue Code or NIRC (P.D. 1158, as amended); Tariff and Customs Code or TCC (P.D. 1464, as amended); Local Government Code of 1991, and the Act Creating the Court of Tax Appeals (R.A. 1125).

3. Administrative rules and regulations are those promulgated by or under the authority of the Secretary of Finance. These are intended to clarify or explain the law and carry into effect its general provisions by providing the details of administration and procedures. These are valid only as long as they do not contradict the law and contravene the Constitution.

4. Administrative rulings and opinions on tax laws are interpretations which are issued by implementing agencies involved like the Bureau of Internal Revenue (BIR) and the Bureau of Customs (BOC). Rulings on tax questions in the form of "Opinions" are also rendered by the Secretary of Justice who is the chief legal officer of the government. It is an accepted principle that the interpretation placed upon a statute by the executive officer whose duty is to enforce it is entitled to great respect by the courts. Nevertheless, such an interpretation is not conclusive and will be ignored if judicially found erroneous.[3]

5. Judicial decisions are promulgated by the Supreme Court and the Court of Tax Appeals (CTA) in interpreting tax laws. These form part of the legal system of the Philippines.[4] The decisions of the CTA are appealable to the Supreme Court pursuant to Article VIII, Section 5 (2) (b) of the Constitution. This provision empowers the Supreme Court to review, revise, reverse, modify or affirm on appeal or certiorari final judgment of lower courts, the CTA included, in all cases involving the legality of any tax, impost or assessment.

B. *Limitations on Power of Taxation*

The legislature's exercise of the power to tax is not absolute. Certain limitations are set up to prevent abuse or misuse of the tax power. These restrictions are classified into inherent and constitutional limitations.

1. **Inherent Limitations**

These limitations go into nature of taxation. They are not embodied in the law nor in the Constitution. They include the (a) requirement of public purpose; (b) prohibition against delegation of the taxing power; (c) exemption of government entities from taxation; (d) international comity; and (e) territorial jurisdiction.

a. *Public Purpose*

A tax is said to be for a public purpose if it is levied for the support of the State or for some recognized objects of government or to promote the welfare of the community. However,

> *"the phrase 'public purpose' as applied to taxation is now given the broadest interpretation so as to include even indirect public advantage or benefit. The mere fact that the tax will be directly enjoyed by a private individual does not make it invalid so long as some link to the public welfare is established. Thus, the use of tax revenues for the support of particular industries vital to the national economy, the clearance of slums and the construction of homesites for deserving citizens, and the payment of retirement or death gratuities to civil servants or their heirs are also considered valid public purposes."*[5]

On the other hand, levying taxes for a private end is compared to a daylight robbery. Thus,

> *"x x x (t)o lay with one hand the power of the government on the property of the citizen and with the other bestow it upon favored individuals to aid private enterprises and build up private fortunes is nonetheless a robbery because it is done under a form of law and is called taxation."*[6]

When a tax is levied other than for a public purpose, any taxpayer may sue the government to prevent its unlawful collection. He has the right to stop illegal expenditures of money raised by taxation and to question the validity of tax statutes in court.[7] But a taxpayer is not relieved from the obligation of paying a tax merely because of his belief that it is being

misappropriated by certain officials. Otherwise, collection of taxes can be hampered resulting in the paralyzation of important governmental functions.[8]

b. *Non-Delegation of Taxing Power*

This is based on the principle of "potestas delegata non potest delegar"i - what has been delegated cannot furthermore be delegated. The rationale is that the people have already chosen to entrust the power to tax to the good judgment of Congress. A violation of this trust arises if Congress allows another body which is not authorized by the people to exercise such power. The rule, however, admits of recognized exceptions:

(1) Delegation to the President - For purposes of practicality and expediency, the Constitution expressly allows Congress to "authorize the President to fix within specified limits, and subject to such limitations and restrictions as it may impose, tariff rates ... and other duties or imposts within the framework of the national development program of the Government."[9]

(2) Delegation to Local Governments - Under the Constitution, each local government unit is expressly conferred "the power to create its own sources of revenues and to levy taxes, fees and charges subject to such guidelines as the Congress may provide, consistent with the basic policy of local autonomy."[10]

Giving flesh to this provision is the 1991 Local Government Code which incorporates two major local government tax laws, the Local Tax Code (LTC) and the Real Property Tax Code (RPTC). The LTC was the primary law governing the exercise by local government units of the taxing and other revenue-raising powers, while the RPTC governed the appraisal and assessment of real property for purposes of taxation by the provinces, cities and municipalities, as well as the levy, collection and administration of the real property tax.

(3) Delegation to Autonomous Regions - At present there is only one autonomous region, Muslim Mindanao. An autonomous region consists of provinces, cities, municipalities and geographical areas sharing common and distinctive historical and cultural heritage, economic and social structures, and other relevant characteristics.[11] The Constitution mandates the Congress to pass the organic act for the autonomous region which, among others, authorizes the legislative assembly of the autonomous government to exercise the legislative power to create sources of revenues within its territorial jurisdiction, subject to the provisions of the Constitution and national laws.[12]

(4) Delegation to Administrative Agencies - There are certain aspects of the taxing process that are not legislative in nature and may therefore be

vested in an administrative body.[13] The rationale arises from practical considerations:

> *"With the modern complexities of modern life, the multiplication of the subjects of government regulation and the increased difficulty of administering laws, it was found that neither the legislature nor the courts were equipped to administer them. The legislature is not always in session. Its members can only agree on general policies but not on matters of detail. Even if they could agree on details, there is danger that too detailed control and regulation on the part of the statute creating administrative bodies may hamper their efficiency and render them impotent in the face of ever changing conditions. The legislature, therefore, neither has the time nor the competence to possibly foresee every contingency in the particular problem it is seeking to control. Reluctantly at first, and later with persistency and determination, the legislature begun until it became customary for it to delegate to each newly created instrumentality of the executive department the power to make the regulations necessary to carry the statute into effect."*[14]

Purely administrative functions include the power to value property for taxation pursuant to fixed rules, the power to assess and collect taxes, and the power to perform details of computation, appraisement, and adjustment, and the delegation of such details.[15]

In all the foregoing instances, the most important prerequisite for valid delegation of the "legislative power to tax" is that

> *"x x x the law must be complete in all its essential terms and conditions when it leaves the legislature so that there will be nothing left for the delegate to do when it reaches him except to enforce it. If there are gaps in the law that will prevent its enforcement unless they are first filled, the delegate will then have been given the opportunity to step in the shoes of the legislature and exercise a discretion essentially legislative in order to repair the commission. This is invalid delegation."*[16]

Thus, the automatic appropriation for payment of foreign debts pursuant to PDs 81, 1177, and 1967 was considered valid delegation of legislative power.

> *"Although the subject presidential decrees do not State specific amounts to be paid, necessitated by the very nature of the problem being addressed, the amounts nevertheless are made certain by the legislative parameters provided in the decrees. The Executive is not of unlimited discretion as to the amounts to be disbursed for*

debt servicing. The mandate is to pay only the principal, interest, taxes and other normal banking charges on the loans, credits or indebtedness, or on the bonds, debentures or security or other evidences of indebtedness sold in international markets incurred by virtue of the law, as and when they shall become due. No uncertainty arises in executive implementation as the limit will be the exact amounts as shown by the books of the Treasury."[17]

c. *Exemption of Government Agencies*

The imposition of taxes on government entities results not only in the absurd situation of the Government transferring money from one pocket to another, but also to unnecessary workloads. Further, the operation of the government is unduly impeded.[18]

On the other hand, there is no legal prohibition against government taxing itself.[19] Government corporations performing proprietary functions like the Philippine National Railways are generally taxed in the absence of tax exemption provisions in the law creating them.[20]

d. *Limitations of Territorial Jurisdiction*

Like all powers of the State, taxation stops at the frontier. The State is supreme only within its territory. Any attempt to extend the exercise of power by one State over the territory of another is considered undue interference in the affairs of the latter in violation of international law principles of equality and independence of all States. More important, however, is the practical consideration that a State is able to enforce tax legislations only within its territory. "It cannot reach over into another jurisdiction to seize upon person or property for purposes of taxation."[21]

A State may not tax property outside its borders or lay an excise or privilege tax upon the exercise or enjoyment of a right or privilege in another State derived from the laws of the latter and therein exercised and enjoyed.[22] One accepted exception to the foregoing principle, however, is with regard to a person who lives in one State but also receives protection in another State because either he is a citizen or a resident of the latter. In this case, he is subjected to tax laws of both States.

e. *International Comity*

It refers to "courteous and friendly agreement and interaction between nations" or "the informal and nonmandatory courtesy sometimes referred to as a set of rules to which the courts of one sovereignty often defer in determining questions where the laws or interests of another sovereignty are involved."[23] Pursuant to this principle, States or governments do not

impose taxes over one another. This is founded on the following reasons: one State cannot exercise its sovereign power over another in view of sovereign equality among States; when a representative of a sovereign enters the territory of another, it is impliedly understood that he does not intend to degrade the dignity of his State by placing himself under the jurisdiction of another; and the international law rule that a foreign government may not be sued without its consent.[24]

2. **The Constitutional limitations**

Constitutional limitations are those contained in the Constitution, including the Bill of Rights.

> *"Although inherent and indispensable, (taxation and the other) fundamental powers of the State are not without restrictions. As ours is a government of limited powers, even these prerogatives may not be exercised arbitrarily to the prejudice of the Bill of Rights. The presumption in libertarian societies is in favor of private rights and against attempts on the part of the State to interfere with them. xxx Hence, the exercise of these fundamental power is subject at all times to the limitations and requirements of the Constitution and in proper cases be annulled by the courts of justice."*[25]

a. *Due Process of Law*

This limitation proceeds from the provision stating that "No person shall be deprived of life, liberty or property without due process of law."[26] Conversely, a person may be deprived of his life, liberty or property if the requirements of due process are observed. There is due process if the deprivation of life, liberty and property is done under the authority of law that is valid and in accordance with the prescribed methods of procedure.[27]

To illustrate, a law imposing a tax for private purposes or which is beyond the jurisdiction of the government to levy and collect violates the due process clause and is therefore void.[28] If the tax law which is judicially declared invalid is enforced, another violation of the due process clause is committed.[29] Where notice to the delinquent taxpayer is required by law before he may be deprived of his property in a public auction sale (in payment of his tax liabilities), failure to give such notice is denial of his right to due process.[30]

A system of taxation which denies a taxpayer a fair opportunity to assert his substantial rights before a competent tribunal is invalid being violative of the same constitutional guarantee. Procedural due process requires opportunities to be heard before judgment is rendered affecting one's person or property.

b. *Equal Protection of Law*

The requirement on the equal protection of law also springs from the due process clause of the Constitution.[31] The provision signifies that all persons subject to legislation shall be treated equal under like circumstances and conditions both in the privileges conferred and liabilities imposed. This prohibits class legislation which discriminates against some and favors others. As long as there are rational grounds for doing so, the Congress may group the persons or properties to be taxed and it is sufficient if all of the same class are subject to the same rate and the tax is administered impartially upon them.

c. *Uniformity and Equality*

The provision that the rule of taxation shall be uniform and equitable and that the Congress shall evolve a progressive system of taxation is a concomitant of the equal protection guarantee.[32] It implies that all taxable articles or properties of the same class shall be taxed at different amounts provided that the rate is uniform on the same class everywhere.

(1) **Uniformity of Operation Throughout the Tax Unit** - This rule requires uniform application and operation, without discrimination of the implementation of the tax laws regardless of the place and of the subject. The tax for national purpose must be uniform and equal throughout the country.[33]

(2) **Equality in Burden** - Uniformity in taxation implies equality in burden. This springs from the premise that when legislation imposes a single tax upon all persons, properties or transactions, inequality would result if they are not similarly treated. The rule of uniformity has been interpreted as equivalent to the requirement of valid classification under the equal protection guarantee. Uniformity in taxation is effected through the apportionment of the tax burden among the taxpayers which under the Constitution must be equitable. The concept of equity in taxation requires that such apportionment be more or less just, in the light of the taxpayers' capability to shoulder the tax burden and if warranted in certain cases, on the basis of the benefits or protection that the taxpayers receives from the government.[34]

The requirement of equity in taxation also implies a reasonable classification of the entities or individuals who are to be affected by the tax. It is always a rule that a tax differentiation should always be based on material substantial differences, otherwise, the guarantee of equal protection of the laws and the uniformity rule will be infringed.[35]

d. *Non-Imprisonment for Debt*

No person shall be imprisoned for debt or non- payment of a poll tax. This means that a person cannot be incarcerated for failure to pay a residence tax. The only penalty for delinquency is the payment of surcharge which is not prohibited by the Constitution.[36] But a person may be subjected to imprisonment for violation of the residence tax law, or any other tax laws, for reasons other than nonpayment of taxes.[37]

e. *Non-Impairment of Contractual Obligations*

The prohibition on impairment of obligation and contract[38] means that the law cannot alter the relationship that results from a contract without the consent of each of the parties thereto.

f. *Non-Infringement of Religious Freedom*

It is provided that no law shall be made respecting an establishment of religion or prohibiting the free exercise thereof, and the free exercise and enjoyment of religion and worship shall forever be allowed.[39] It has been held that the imposition of license fees (or taxes) on the distribution and sale of Bibles and other religious literatures not for purpose of profit by a non-stock, non-profit corporation is illegal for it violates the above constitutional guarantee. Freedom of religion carries with it the right to disseminate religious beliefs and information.[40]

g. *Non-Appropriation for Religious Purposes*

The Constitution provides that no public money or property shall ever be appropriated or used directly or indirectly for any religious purposes.[41] This provision is based on the requirement that taxes can only be levied for public purposes. The Congress is without power to appropriate funds for private purpose like the construction of feeder roads owned by a private person.[42] However, if the public is the beneficiary, the expense is justified.

h. *Non-Taxation of Religious or Charitable Entities and Properties*

This limitation is based on the provision that exempts "charitable institutions, churches, parsonages or convents appurtenant thereto, mosques and non-profit cemeteries, and all lands, buildings, and improvements actually, directly and exclusively used for religious, charitable or educational purposes" from taxation.[43] This exemption applies only to the use of property and not to the ownership thereof. The exemption extends to facilities which are necessary for the accomplishment of said purposes as in the case of a hospital, a school for training nurses, a nurses' home, etc.

i. *Non-Taxation of Non-Stock, Non-Profit Educational Institutions*

Not found in the 1973 Constitution, this limitation of the State power to tax states:

> *"(3) All revenues and assets of non- stock, non-profit educational institutions used actually, directly, and exclusively for educational purposes shall be exempt from taxes and duties. Upon the dissolution or cessation of the corporate existence of such institutions, their assets shall be disposed of in the manner provided by law."*
>
> *"Proprietary educational institutions, including those cooperatively owned, may likewise be entitled to such exemptions subject to the limitations provided by law including restrictions on dividends and provisions for investment."*
>
> *"(4) Subject to conditions prescribed by law, all grants, endowments, donations, or contributions used actually, directly, and exclusively for educational purposes shall be exempt from tax."*[44]

Subparagraph 3 has been interpreted to include all taxes on the revenues and assets of non-stock non- profit educational institutions, from income tax to customs duties, whether imposed by the national or the local governments. However, this privilege is available only to revenues and assets used actually, directly, and exclusively for educational purposes. Consequently, income and assets from non-educational endeavors are taxable.[45]

While stock or profit-oriented educational institutions are not covered by the aforesaid Constitutional provision a law may be passed to extend to them the same privilege.

Although subparagraph 4 exempts all grants, endowments, donations, or contributions used actually, directly, and exclusively for educational purposes from tax, the Constitution still requires that a law shall be first enacted to set the conditions for its enjoyment.

In any case, however, it must be borne in mind that real properties of educational institutions whether proprietary or not, are exempt from property tax.[46]

j. *Other Constitutional Limitations*

Aside from the limitations explained above, there is also a provision in the Constitution that "no law granting any tax exemption shall be passed

without the concurrence of a majority of the members of the Congress."[47] This requirement is intended to prevent the indiscriminate grant of tax exemptions. Another limitation concerns the power of the President to veto any particular item or items in an appropriation, revenue or tariff bill.[48] The veto power may affect only item or items to which the President objects.

The other limitation is on the part of the Congress. Congress can not take away from the Supreme Court the power given to the latter by the Constitution as the final arbiter of tax cases.[49]

C. The Legal Process of Taxation

Under the present system of government, the head or chief executive is the President. The legislative function is vested in the bicameral Congress. The Senators are elected at large[50] while the Members of the House of Representatives are elected from legislative districts apportioned among the provinces, cities and the Metro Manila area in accordance with the number of their respective inhabitants, and on the basis of a uniform and progressive ratio. Other House members are those who shall be elected through a party-list system of registered national, regional, and sectoral representatives or organizations.[51]

The Department of Finance is the principal office charged with the formulation and implementation of tax policies. The Secretary of Finance recommends to the President the tax policy measures which are submitted to the Congress. Once passed by Congress, the laws are implemented by the Department of Finance through its major operating bureaus: the Bureau of Customs and the Bureau of Internal Revenues.

In the local government level, the taxes are levied by the respective Sanggunians (legislatures) of the provinces, cities, municipalities and barangays, pursuant to the 1991 Local Government Code.

In general, a local tax measure becomes an ordinance once passed by the Sanggunian and approved by the local chief executive (Provincial Governor, City or Municipal Mayor, Barangay Captain). The local chief executive may veto the measure, but the Sanggunian can override the veto by a two-thirds vote of all its members. The Code provides for review of the ordinances in the following manner: that of component city and municipal ordinances by the Sangguniang Panlalawigan; and that of barangays by respective sangguniang bayan or panlunsod.

As regards the Real Property Tax impositions, the provinces, cities, and Metro Manila municipalities are primarily responsible for the proper, efficient and effective administration of the realty tax.[52] The assessment of the property is done by the assessor whose decision is appealable to the Local

Board of Assessment Appeals. The decision of the latter is further reviewable by the Central Board of Assessment Appeals.

III. BUDGET

A. *Nature of Budgeting*

The budget is defined as the financial plan of the government. It is designed to accomplish the political, economic, and social objectives of the government as well as to carry out its administrative policies. As a financial plan, it proposes the allocation of the scarce financial resources among the many competing demands of the government. It specifies the programs, projects, services and activities for which specific amounts of the public funds are proposed and allocated. The budget also indicates the manner in which the government intends to raise funds with which to support the estimated expenditures recommended in the budget. In short, the budget translates the program of government into monetary terms.

The budget is more than a financial document. It has been regarded as a system of policy-making decisions for the allocation of scarce financial resources among competing needs, a system by which policies are implemented and for which execution controls, both administrative and legislative, are established.

The content and structure of the budget document is related to the various functions the budget performs:

1. It is a legal document, an act of the legislative department whereby the Executive is authorized to incur certain expenditures and to levy taxes, with its own requirements for content and structure.

2. It is a political document setting forth the financial policies of the government.

3. It is a management tool and the basis for accounting, specifying for each department and each agency how much they can spend and for what purpose.

4. Finally, it is a document indicating the economic significance of the Government's policies and programs.

B. *Budget Formulation*

In the formulation of the national budget, the finances of government are analyzed and determined as the aggregate of revenue, expenditure and debt of all units of government, including the national government and its agencies

and instrumentalities, local government units and government-owned-and-controlled corporations. The national government budget is evolved within the framework of the local impact of government activity on the national economy. The budgets of government corporations and local governments should be consistent in form and timing with that of the national government to facilitate comprehensive evaluation.

The budget process of local government units is undertaken by the local government units themselves under the concept of local autonomy. The 1991 Local Government Code governs the process and assigns to the Department of Budget and Management and next higher level sanggunians the function of reviewing local budgets.

The budget process metamorphosed from the early years of the American period up to the passage of the Jones Law in 1916 when a Budget Office was created within the Department of Finance to exercise the budgeting function. The department's responsibility was to assist in the preparation of an executive budget for submission to the Philippine Legislature.

The Constitution of 1935 established budget policy and procedure, both of which were amplified in a series of laws and executive acts over the years.

The Budget Commission was established by Executive Order (E.O.) No. 25 issued on April 25, 1936. It became a Ministry by virtue of P.D. No. 1405, signed on June 11, 1978. Following the pattern in the United States Federal Government, the Budget Commission was part of the Office of the President and separate from the other fiscal agencies of government that form part of the finance department.

The budget process was established by Commonwealth Act (C.A.) No. 246, known as the Budget Act, which was passed by the Philippine Assembly on December 17, 1937. This law governed the Philippine budget process until June 4, 1954, when Republic Act (R.A.) No. 992 was passed by Congress. These two laws were operative until the improvements instituted during the New Society of Ferdinand Marcos.

A series of budgetary reforms were directed by the Constitution of 1973 and by various presidential decrees that culminated in P.D. No. 1177, the Budget Reform Decree of 1977.

C. *Constitutional Provisions*

There are a significant number of constitutional provisions on budget, a clear indication of the budget's relative importance to the national life. But like those relating to taxation, most of these provisions restrict the authority

of the Congress on budgeting, probably because it involves exercise of discretion over public funds.

The word "budget" has been used to denote "appropriation." Technically, however, an appropriation is an authority pursuant to a law for payment of money out of the National Treasury. The definition reveals two significant points, namely, the enactment of a law and the primary and special purpose of the law which is payment of money out of the National Treasury. Thus, when the Constitution ordains that "No money shall be paid out of the Treasury except in pursuance of an appropriation made by law,"[53] it means that all releases of government funds must first be authorized by the Congress through the enactment of appropriation laws.

Appropriations are dichotomized into general and special.[54] A general appropriation is "an authorization of the lawmaking body to take out from the national treasury such amount of money, not otherwise set aside for another purpose, as is needed to pay for personal services and operations of the government covering a certain period of time, termed as fiscal year."[55] On the other hand, a special appropriation bill "is designed to supplement the items of appropriation authorized in the general appropriations law or to authorize funds for new programs or activities which have not been included in the budgetary act."[56]

Article VII, Section 22 of the Constitution refers to a general appropriation. It requires the President to "submit to the Congress within thirty days from the opening of every regular session, xxx a budget of expenditures and sources of financing, including receipts from existing and proposed revenue measures" to be made "as the basis of the general appropriations bill." [Italization ours] While as a rule it is discretionary on the President to propose legislative measures, the Constitution imposes a duty on him to prepare and submit the annual budget to Congress.

Two important points should be highlighted to understand the aforementioned provision. First, of the three branches of the Government, the Executive, is tasked with the submission of the annual budget inasmuch as, relative to the other branches, it is in the best position to determine the financial situation of the government. Second, the submission of the general appropriations bill every year is mandated by the Constitution in order to avoid paralyzation of government operations that may arise for failure to pass a law authorizing the release of public funds.

The aforementioned provision, however, does not apply to a special appropriation. The President has full discretion whether or not to sponsor one. Whenever a special appropriations bill is sought to be passed, the Constitution requires that it "shall specify the purpose for which it is intended, and shall be supported by funds actually available as certified by the National

Treasurer, or to be raised by a corresponding revenue proposal therein."[57] The requirement of certification by the National Treasurer precludes legislators from indiscriminately filing bills for infrastructure projects when such could not be implemented because of lack of funds.

The Constitution, in requiring that sources of revenues be indicated in the bill, hopes to bring the level of expenditure proposals in both the general and special appropriations bills within the level of revenue measures recommended either in the annual budget or in the special appropriation bill.[58]

The appropriations bill, whether special or general, is essentially a legislative measure. Unless otherwise indicated by the Constitution, it follows the ordinary process of enacting a law. Hence, an appropriation bill must observe the rule that it shall embrace only one subject which shall be expressed in its title.[59] This provision aims to apprise the people and the legislators of the contents of the bill to prevent fraudulent attempts to surreptitiously insert provisions in the appropriatio bill such as legislative items which are unpopular or otherwise would not have been passed by Congress. The Constitution further provides that "No provision or enactment shall be embraced in the general appropriations bill unless it relates specifically to some particular appropriation therein. Any such provision or enactment shall be limited in its operation to the appropriation to which it relates."[60]

Once filed with the House of Representatives, the appropriation bill passes three readings on separate days.[61] The first reading announces only the title and the number of the bill which is then assigned to appropriate committees for study. The version approved by the committees is then presented to the floor for the second reading. It is at this stage that the bill is deliberated upon and amendments and modifications are made. Three days before its final reading, it is required that printed copies of the final form of the bill be distributed to Congressmen, unless the President certifies to the necessity of its immediate enactment to meet a public calamity or emergency.[62] On the third reading, only the title and the number is read. No more amendment is allowed and the vote is immediately taken thereafter where the yeas and nays are entered in the Journal.[63] A majority vote of the members present is required to pass the bill. The appropriations bill as approved by the House of Representatives is then presented to the Senate where it shall undergo the same procedure. In case of differences in the version of the two Houses, a conference committee is formed to draw a compromise version of the bill which is then voted upon by the two Houses separately.

The authority of the Congress to amend or modify the budget proposed by the President is, as a rule, unlimited. The Constitution, however, does not allow Congress to increase the appropriations recommended by the President for government operations as specified in the budget.[64]

The bill approved by Congress is presented to the President for approval.[65] If he signs it, the bill becomes a law. He may veto it and return the same with his objections to the House of Representatives which shall enter the objections in its Journal and proceed to reconsider it.[66] If, after such reconsideration, two-thirds of all the Members of the House agree to pass the bill, it shall be sent, together with the objections, to the Senate. If approved by two-thirds of all members of the Senate, the bill becomes a law without the need of Presidential approval.[67] The bill also becomes a law when the President fails to communicate his veto to the House of Representatives within thirty days from receipt thereof. The effect of his inaction is as if he had signed it.[68]

The general rule is that the President cannot just veto one provision of the bill. He must veto the entire bill even if he does not like only one word in it. The rule, however, admits of two exceptions: (1) when the bill itself provides that in case the President vetoes any of its provisions the rest shall remain valid and, (2) in the case of the general appropriations bill where the veto by the President of any of its particular item or items does not affect other items to which he does not object.[69] The rationale for the second exception is to avoid a situation where even insignificant or minor disagreements in the budget between the President and the Congress may prevent the general appropriations bill from becoming a law, resulting in paralyzation of government operations and grounding of important projects.

The Constitution, in order to prevent a situation where the government is without any operating budget, provides that,

> *"If, by the end of any fiscal year, the Congress shall have failed to pass the general appropriations bill for the ensuing fiscal year, the general appropriations law for the preceding fiscal year shall be deemed reenacted and shall remain in force and effect until the general appropriations bill is passed by the Congress."*[70]

D. *Restrictions on Budgeting*

The entire budget process is replete with legal and constitutional restrictions to safeguard the disbursement of public funds and to prevent the legislature from unduly taking advantage of this power. The Constitution mandates the Congress to enact a law prescribing the form, content, and manner of preparation of the budget.[71]

The Constitutional limitations, some of which have already been discussed above, are:

1. Congress may not increase the appropriations recommended by the President for the operation of the Government.[72]

2. All provisions of the general appropriations bill shall relate specifically to some particular appropriation therein and shall be limited in its operation to the appropriation to which it relates.[73]

3. The procedure in approving appropriations for Congress shall strictly follow the procedure for approving appropriations for other departments and agencies.[74] This provision ensures that no sub rosa or secret appropriations are passed by Congress.

4. A special appropriations bill shall (1) specify the purpose for which it is intended and (2) shall be supported by funds actually available as certified by the National Treasurer, or to be raised by a corresponding revenue proposal therein.[75]

5. No law shall be passed authorizing any transfer of appropriations. However, the President, the President of the Senate, the Speaker of the House of Representatives, the Chief Justice of the Supreme Court, and the heads of Constitutional Commissions may, by law, be authorized to augment any item in the general appropriations law for their respective offices from savings in other items of their respective appropriations.[76] This Constitutional provision puts in doubt the validity of Section 45 of the Budget Reform Law of 1977 (P.D. No. 1177, as amended) which authorizes use of personal savings to create additional positions in an office. However, until and unless declared unconstitutional by the courts, Section 45 of the Budget Law is considered legal.

6. In deference to the principle of separation of Church and State, the Constitution provides, inter alia, that no public money or property shall be appropriated, applied, paid, or employed, directly or indirectly, for the use, benefit or support of any sect, church, denomination, sectarian institution, or system of religion, or of any priest, preacher, minister, or other religious teacher or dignitary as such, except when the priest, etc., is assigned to the armed forces, or to any penal institution, or government orphanage or leprosarium.[77]

7. All money collected on any tax levied for a special purpose shall be treated as a special fund and paid out for such purpose only. If the purpose for which a special fund was created has been fulfilled or abandoned, the balance, if any, shall be transferred to the general funds of the Government.[78]

8. In order for Judiciary to enjoy fiscal autonomy and hence, insure its independence, Congress is prohibited from reducing the appropriations for the Judiciary below the amount appropriated for the previous year.[79] However, Congress may increase the appropriations.

9. The salaries of the President, the Vice President, and the Chairman and the Members of the Constitutional Commissions (namely, the Civil Service Commission, the Commission on Elections, and the Commission on Audit) are determined by law and may therefore be increased or decreased.[80] The provision that their salaries shall not be decreased during their tenure,[81] means that any reduction in their salaries by Congress shall take effect only after their tenure.

10. It is mandated that education should have the highest budgetary priority.[82] This was interpreted by the Supreme Court as the highest among departmental budgets,[83] that is, over that of the Department of National Defense, Department of Public Works, etc., even though allocation for debt servicing may be higher.

For example, 25% of the budget goes to the DECS, the highest amount in the departmental budget, while 50% goes to debt servicing, according to the Supreme Court, this is still valid. Even if 90% of the debt being serviced were incurred for the modernization of the Armed Forces, thus chargeable to the Department of National Defense and making it the highest among the departmental budget, no objection could be made.

Other legal or statutory restrictions on budgeting touch on the aspect of foreign borrowings. The Development Budget Coordination Committee (DBCC) and a National Economic Development Authority (NEDA) sub-committee study ceilings applicable to revenues, expenditures and borrowings and determine budget levels. The DBCC is composed of the Budget Secretary as chairman and the Economic Planning Secretary (the Director General of the National Economic Development Authority), the Central Bank Governor and the Secretary of Finance as members.

The DBCC estimates the anticipated revenues for the government on the basis of historical performance and projections of economic conditions for the incoming year. It likewise estimates the cost of implementing the projects needed to achieve the goals established in the development plan. If it is necessary to borrow in order to meet the financial gap between projected revenues and the desired level of expenditures, the DBCC also estimates the maximum amount that the government can borrow without endangering its financial position. It is on the basis of its studies that a recommendation is made to the President, on the total budgetary ceilings upon which the budget is framed.[84]

The government borrows from foreign sources to acquire the foreign exchange requirements of development projects. These requirements represent the amounts, in foreign currency, needed to import machines and equipment necessary for the implementation of these projects. The govern-

ment must also turn to foreign sources of capital on account of the absence of a long-term domestic capital market and the limited savings in the country.

By borrowing from foreign sources, the government takes advantage of long-term loans which are readily available and the lower interest rates in international capital markets. Foreign borrowings, however, are governed by certain rules and regulations, specifically R.A. No. 4860 as amended by R.A. No. 6142 and further amended by P.D. No. 621-A.

Section 1 of P.D. No. 621-A provides that "the total amount of loans, credits, or indebtedness...shall not exceed five billion U.S. dollars or its equivalent in other foreign currencies at the time the loans, credits, or indebtedness are incurred in terms of payments of not less than 10 years...

The same section instructs the Central Bank to "promulgate and enforce such measures...to reduce the external debt service requirements to an annual level not exceeding twenty percent (20 percent) of the average of foreign exchange receipts of the immediate preceding year."

One such measure provides that the country's borrowings may not exceed three percent (3.0 percent) of the gross national product (GNP) on the average during the Five-Year Development Plan period. These levels are strictly adhered to so that the country can afford to pay its foreign obligations without adverse effects on the economy.

IV. ACCOUNTING AND AUDITING

A. *Definitions*

Accounting is defined as "the art of recording, classifying and summarizing, in a significant manner, and in terms of money, transactions and events which are, in part at least of a financial character and interpreting the results thereof." Its primary function is to measure and communicate financial and business data as it gives meaning to financial reports by explaining the results of transactions in terms of profit and loss and current financial positions.

Auditing on the other hand is the examination of information by a third party other than the preparer or user with the intention of establishing its reliability, and the reporting of the results of this examination with the expectation of increasing the usefulness of the information to the user.

B. *Legal Framework*

The constitutional basis for accounting and auditing as a component of public finance is Article IX (D), Section 2 of the Constitution, which provides that:

> *"(1) The Commission on Audit shall have the power, authority, and duty to examine, audit, and settle all accounts pertaining to the revenue and receipts of, and expenditures or uses of funds and property, owned or held in trust by, or pertaining to, the Government, or any of its subdivisions, agencies, or instrumentalities, including government-owned or controlled corporations with original charters, and on a post-audit basis: (a) constitutional bodies, commissions and offices that have been granted fiscal autonomy under this Constitution; (b) autonomous state colleges and universities; (c) other government-owned or controlled corporations and their subsidiaries; and (d) such non-governmental entities receiving subsidy or equity, directly or indirectly, from or through the Government, which are required by law or the granting institution to submit to such audit as a condition of subsidy or equity. However, where the internal control system of the audited agencies is inadequate, the Commission may adopt such measures, including temporary or special pre-audit, as are necessary and appropriate to correct the deficiencies. It shall keep the general accounts of the Government and, for such period as may be provided by law, preserve the vouchers and other supporting papers pertaining thereto.*
>
> *2) The Commission shall have exclusive authority, subject to the limitations in this Article, to define the scope of its audit and examination, establish the techniques and methods required therefore, and promulgate accounting and auditing rules and regulations, including those for the prevention and disallowance of irregular, unnecessary, excessive, extravagant, or unconscionable expenditures, or uses of government funds and properties."*

Pursuant to this constitutional mandate, the Auditing Code of the Philippines was promulgated in 1979 (P.D. 1445). As it proceeds mainly from the basic law, the Code only amplifies, elaborates, specifies, and implements.

Auditing plays an important role in public finance. Under the declaration of policy in the Auditing Code, it is stated that all resources of the government shall be managed, spent and utilized in accordance with law and regulations; and safeguarded against loss or wastage through illegal or improper disposition, with a view to ensuring efficiency, economy and effectiveness in the operations of government.

The responsibility to uphold the above policy faithfully rests directly with the chief or head of the government agency concerned. This is the co-called fiscal responsibility which, as provided in Sec. 4 of the Code, is to be shared to the greatest extent by all those exercising authority over the financial affairs, transactions, and operations of the government agency.

The Code's provision on fiscal responsibility is a reaffirmation of a similar provision in P.D. 898, the earlier law that restructured COA. The earlier law defines and delineates the responsibility of the auditor vis-a-vis that of the audited agency, and draws the line between COA and the rest of the government.

ENDNOTES

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[3]People vs. Fernandez, 59 Phil. 272.

[4]Article 8, Civil Code.

[5]Isagani Cruz, *Philippine Constitutional Law*, p. 88.

[6]Loan Association v. Topeka, 30 Wall 655, cited in Nolledo, p. 16.

[7]People v. Vera, 65 Phil. 56; Pascual v. Secretary of Public Works, 110 Phil. 331; Sanidad v. COMELEC, L-44640, October 12, 1976, cited in Hector S. De Leon, The *Fundamentals of Taxation* (Manila: Rex Bookstore, 1988), p. 39.

[8]Ibid.

[9]Art. VI, Sec. 29 (2), Constitution.

[10]Art. X, Sec. 5, ibid.

[11]Art. X, Sec. 15, ibid.

[12]Art. X, Secs. 19 and 20, ibid.

[13]De Leon, pp. 40-41.

[14]Neptali A. Gonzales, *Administrative Law*, (1979) p. 26.

[15]84C.J.S. 59, Cervantes vs. Auditor General, 91 Phils. 359, cited in De Leon, p. 41.

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[20]De Leon, p. 42.

[21]71 Am. Jur. 2d 408-409, cited in De Leon, p. 3.

[22]51 Am. Jur. 87-88, cited in De Leon, p. 43.

[23]*Webster's Third International Dictionary*, 1976 ed., footnote in De Leon, p. 42.

[24]French Republic vs. Jefferson County, 252 S.W. 124, cited in De Leon, p. 42.

[25]Isagani Cruz, *Philippine Constitutional Law*, p. 36. Those in brackets ours.

[26]Art. III, Sec. 1, Constitution.

[27]De Leon, p. 25.

[28]Ibid.

[29]Ibid.

[30]Valencia v. Jimenez, 11 Phil. 492; Aragon v. Jorge, 85 Phil. 246, cited in De Leon, p. 25.

[31]Art. 3, Sec. 1, Constitution.

[32]Art. VI, Sec. 28 (1), Constitution; De Leon, p. 28.

[33]De Leon, p. 28.

[34]Ibid., p. 30.

[35]Ibid.

[36]Sec. 38 (e) Art. 6 of the Local Tax Code, cited in De Leon, p. 31.

[37]De Leon, p. 31.

[38]Art. III, Sec. 10, Constitution.

[39]Art. III, Sec. 5, ibid.

[40]American Bible Society v. City of Manila, 101 Phil. 368, cited by De Leon, p. 33.

[41]Art. VI, Sec. 29 (2), Constitution.

[42]Pascual v. Secretary of Public Works, 110 Phil. 331, cited in De Leon, p. 33.

[43]Art. VI, Sec. 28 (3), Constitution.

[44]Art. XIV, Sec. 4 (3) and (4), ibid.

[45]Jose C. Vitug, *Compendium of Tax Law and Jurisprudence*, 2d ed., pp. 19-20.

[46]See preceding subtopic.

[47]Art. VI, Sec. 28 (3), Constitution.

[48]Art. VI, Sec. 27, (2), ibid.

[49]Art. VIII, Sec. 5 (2) (b), ibid.

[50]Art. VI, Sec. 2, ibid.

[51]Art. VI, Sec. 5 (1), ibid.

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[54]H. Mendoza and A.B. Lim, "Constitutional Fiscal Provisions," *The New Constitution,* (Manila: GIC Enterprises & Co., Inc., 1976) p. 207.

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[64]Art. VI, Sec. 25 (1), Constitution.

[65]Art. VI, Sec. 27 (1), ibid.

[66]Ibid.

[67]Ibid.

[68]Ibid.

[69]Art. VI, Sec. 27 (2), Constitution.

[70]Art. VI, Sec. 25 (7), ibid.

[71]Art. VI, Sec. 25 (1), ibid.

[72]Ibid.

[73]Art. VI, Sec. 25 (2), Constitution.

[74]Art. VI, Sec. 25 (3), ibid.

[75]Art. VI, Sec. 25 (4), ibid.

[76]Art. VI, Sec. 25 (5), ibid.

[77]Art. VI, Sec. 29 (2), ibid.

[78]Art. VI, Sec. 29 (3), ibid.

[79]Art. VIII, Sec. 3, ibid.

[80]Art. VII, Sec. 6, and Art. IX-A, Sec. 3, ibid.

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CHAPTER 5

POLITICS AND FISCAL ADMINISTRATION

I. INTRODUCTION

A. Fiscal Administration and the General Welfare
B. The Relationship
C. A Model

II. THE SYSTEM

A. The Process

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B. The Interest Groups

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IV. SUMMARY

POLITICS AND FISCAL ADMINISTRATION

I. INTRODUCTION

A. *Fiscal Administration and the General Welfare*

Ideally, fiscal administration should derive its substance and meaning from the concept of general welfare. For developing countries embarking on a development process, the term "general welfare" essentially means the welfare of the avowed beneficiaries of development, the poor. In this chapter, this is the bias adopted in correlating fiscal administration to politics.

B. *Relationship*

Fiscal administration does not operate in a vacuum. The formulation and execution of fiscal policies have to contend with the role politics plays in the process. The relationship between fiscal administration and politics is a dynamic interchange of effects and causes. In other words, fiscal policies - as the end-products of fiscal administration - influence as much as they are influenced by the political process. This is because fiscal administration is done within a political system. Others would go as far as to say that fiscal administration itself is a political process.

C. *A Model*

As far as we are concerned, there is no known model of the politics-fiscal administration relationship which can appropriately be used for purposes of discussing the politics of fiscal administration of developing countries. Most of the paradigms used at present are substantially Western - Pendleton Herring's, Richard Musgrave's, Aaron Wildavsky's, etc. Of the limited literature on fiscal administration for developing countries, it is unfortunate that no explicit model has evolved for fruitful usage.

While model-building is not the primary goal of this chapter, we hope to present a tentative framework for a discussion of the politics fiscal administration system within the context of developing countries.

To understand how the system works, some assumptions have to be set. First, it is assumed that the purpose of fiscal administration is to realize desired objectives through fiscal policies. Second, we should recognize that which is obvious: the formulation and execution of such fiscal policies are done within a political context. Third, there is a process by which the "politicalization" of fiscal policies is done. This means further that there are actors of the process. Fourth, the process takes place within a system which

governs how the process works and how the actors behave. Fifth, the system is governed by an ideology which represents a composite of the economic, political, and social values of society.

This discussion intends to show the fiscal administration process within the political perspective. It will be seen that due to the influence of political factors on the fiscal process, fiscal policies are often altered on both intentions and substance such that the resulting fiscal policy may not effectively address the economic objectives for which it was originally conceived. The political factors affect the fiscal process in such a way that the fiscal policy obtained reflects more the interests of the stronger political factor or actor. Thus, a policy on tax incentives may favor foreign capital or investment largely because the political process within which the policy is formulated and executed is dominated by actors representing foreign investment.

The problem is how to reconcile the relationship between politics and fiscal administration towards the realization of the general welfare. We have to identify the constraints of fiscal administration which prevent it from producing fiscal policies more in consonance with the welfare of its intended beneficiaries, the poor. We should explore the possibility of changes or reforms that can make the relationship more responsive to development objectives and needs. Corollarily, we shall determine the alternatives to the process and how these options can be instituted.

II. THE SYSTEM

The relationship between politics and fiscal administration can be understood if we look at the system which gives rise to it

The system is composed of: (1) the process, made up of the existing institutions (political or non-political) which serve as mechanisms whereby individual preferences and views are expressed, deliberated upon, and translated into the winning combination of issues; (2) the interest groups (formal or informal) which determine the issues and preferences raised and their strategies of presentation, the conversion of the winning combination or set of preferences into fiscal decisions, and the extent of implementation of such decisions; and (3) the ideology or the structure of the distribution of power in a developing country.

The issues, in this particular discussion, refer to the concerns of fiscal policies such as taxation, budget, and expenditures or borrowings. The process occurs, for example, in determining the size of the budget or who shall have more allocation from it or which sectors should be benefited from a foreign loan. Fiscal policies are the outputs of the interaction between politics and fiscal administration.

A. *The Process*

How are views and demands on fiscal matters expressed? In a free enterprise mixed-economy system of developing countries, representative democracy provides the system whereby individual preferences are made known and advanced.

These preferences are translated through the political process of voting. One writer views the whole range of individual preferences as affecting budgetary decisions such as (1) the size of the budget; (2) how much benefits one should be allocated; and (3) how much costs one should bear.

1. **Voting**

There are two levels of decision-making wherein fiscal decisions can be reached. One is in the level of small-number situations like in a village meeting or in the legislature where a relatively small number of actors are involved and where the issues dealt with are relatively simpler and fewer. Another setting is the large-number situation as in a national election where there are almost an unlimited number of political actors and the range of issues considered is so complex and broad.

Under the theory of representative democracy, the individual expresses his preference through his vote. This vote records his preference during a referendum on issues or when he elects representatives who share his interests.

2. **Vote Maximization**

The translation of individual preferences works because of the vote maximization theory.

This theory, developed by Schumpeter and Downs, is an analogy of the economic concept of the "economic man." It assumes that political action is rational such that both politician and individual voters act in their own self-interest. The voter wants to maximize the net benefits which he obtains from a fiscal policy, that is, the benefits (social goods and services) minus the costs (taxes). The politician desires to maximize votes to win an election or stay in power.

Voters will therefore cast their votes in favor of those who best represent their preferences and interests while the politician will offer programs and support legislation which promote the interest of the voters.

Strategies for expressing the voter's preference and increasing his chances of winning in the process vary depending on the voting rules - how

the voters qualify, how their votes are counted, how the winning vote is determined - and the issues at stake. In cases where the fiscal issues are more than two and are highly complex, the voters and politicians may form platforms and coalitions to combine and pair issues for vote maximization. Logrolling or bargaining may also be resorted to.

B. *The Interest Groups*

Fiscal decisions are means by which group interests are expressed. The political system consists of various actors and factors which influence how individual preferences are expressed and how fiscal decisions reflecting the preferences are reached.

1. **The Formal Actors: Voters, Politicians, and Bureaucrats**

The voters, politicians, and bureaucrats may be considered the formal actors of the political process. The voters represent the consumers and producers of public goods and services. Consumer-voters come into political play depending upon their perception of the effects of issues on their interests. Consumer groups like farmers marketing their products or car manufacturers thus become visible when a decision concerns the determination of budgetary allocation for highways and bridges. More visible are the residents of a particular area which can be served by the roads. Producer-voters such as construction firms also come into the picture.

Politicians, whether belonging to the party in power or to the minority party, necessarily come into play. The system requires politicians to facilitate the translation of individual preferences to a certain degree of rationality in decision- making. Politicians account for the intensity of preferences of their constituents through coalitions and platforms. Thus, the tyranny of the majority is minimized. The representativeness of the political decision or the extent to which a fiscal decision reflects voter preferences is also enhanced by politicians when they offer compromises. Politicians, aside from responding to voter preferences, may generate alternatives and new preferences which they believe desirable, thereby creating new preference patterns which may be more feasible and desirable from the voter's viewpoint.

The bureaucrat represents another formal interest group in the system. The bureaucrat (for administration) represents the bureaucracy which implements or executes the fiscal decisions arrived at during the policy-determination phase of fiscal administration.

The significance of the bureaucrat lies in his role in the implementation of fiscal decisions. His importance derives from his position as repository of public funds, his unique power stemming from the possession of technical

know-how and information, and his bureaucratic control over the governmental machinery.

The bureaucrat, to the extent that he is not a formal political aspirant, is outside the formal political process of election. Thus, the vote maximization theory may not apply to him. This lack of accountability to voters causes the bureaucrat to be indifferent to their preferences. This neutrality is promoted by the roles and status he attaches to his position as a dispenser of governmental goods and services.

When the bureaucrat relates to the politician, the process assumes a greater degree of political interaction. The locus of interaction is budget determination and execution for the bureaucrat's program. Oftentimes, the implementation of an agency's program despite its desirability in terms of perceived benefits and beneficiaries, is compromised by political haggling over the size of its budget.

Even after the process finally results in a fiscal decision, the politician continuously impinges on the bureaucrat's production and delivery of public goods and services. Usually, the politician has granted political demands at the budgeting stage such that he continues to have clout. In a few developing countries where technocrats (highly-skilled bureaucrats occupying critical positions in the bureaucracy) have gained ascendancy, they generally have the upper hand over politicians. Of course, the leader is always a politician but the technocrats may be the actual "power behind the throne."

In many developing countries the technocrat is accorded high esteem and power because he serves in economic planning, budget, monetary, and other related institutions. He is less visible yet his impact on fiscal administration is more to reckon with than the ordinary bureaucrats. This fact is well-recognized by politicians and even by external actors like international banks and other financial institutions. The importance ascribed to the role of the technocrat comes from the perceived importance of technology and administrative capability in development administration among developing countries.

The technocrat's rise in the bureaucracy has evolved new roles, values and power for him. The technocrat is often seen as a veritable "think tank," to the point that sometimes such a role assumption makes it difficult for him to revise a fiscal decision whose outcomes are later proven to be deficient. The role attached to him is often one of infallibility in decision-making. Where the technocrat accede to change a previous fiscal decision, he does it only incrementally. Thus, an original fiscal policy may take on a series of amendments which often irritates the bureaucrat-administrator who implements them.

The values of the technocrat can be very different from the bureaucrat. For one, the technocrat is often removed from day to day administrative work such that he is more of a navigator rather than a driver of the bureaucracy. He tends to be partial to the macro-economic considerations of fiscal administration. Unlike the bureaucrat, the technocrat may not have immediate political interests because he is more certain of political favor from the political leadership. Thus, the technocrat does not have to relate much to the politician or to the voters. The technocrat, who is often a product of Western education and exposure, is sometimes perceived as partial to Western technologies and Western precepts of fiscal administration. To some nationalist writers, the technocrats are detached from the actual needs and demands of the polity.

2. **The Informal Actors:**

a. *Foreign Interest Groups*

The participation of foreign interest groups in fiscal politics of developing countries comes primarily from the pervasiveness of their interests in the latter's economies. In terms of their impact on local politics and fiscal administration, the World Bank-IMF, the multinational corporations (MNCs) and the foreign banking groups dominate. In the determination and execution of local fiscal policies, these interest groups attempt to protect and promote their own objectives. The MNCs' concerns are on their capital interests; the WB-IMF, the repayment of the loans and the implementation of the agreed terms of the loan; and the foreign banking groups on further expansion of their credit participation.

These foreign interest groups prefer to maintain a low profile in local fiscal politics. They do not have to come out in the open anyway - the WB-IMF has regular consultations with Philippine officials due to the enormity of the Philippine foreign debt; the MNC's are represented by local dummies; and the foreign creditors by their Filipino proxies. In the open political contest, these foreign interest groups, express their preferences by financially supporting selected politicians. Where the local technocrats and bureaucrats are more significant in fiscal policy administration, foreign interest groups attempt to influence their nomination and appointment.

Among the interest groups, the foreign interest bloc is the most organized despite the heterogeneity of its membership: industrialists, bankers, international financiers. These three groups act in harmony. They complement and support each other in their capitalist designs. The usual IMF conditions for loans granted to developing countries such as the lifting of tariff controls favor the MNCs because it opens wide the local market to their products. If the recipient country hesitates to agree to the terms of the loan, the IMF can pressure the international credit community to refuse extending

capital loans to the former. Because it is well organized and has enormous resources at its disposal, the foreign interest bloc is powerful enough to dictate economic policies on a developing country.

b. *Domestic Interest Groups*

A domestic interest group consists of voters who have a common interest or a sectoral concern in the economy which they attempt to advance in the political process either by voting or non-voting means. The interests advanced and the groups representing such reflect the economic and social structures of the country.

In developing countries, the interest groups often represent the traditional agro-mineral concerns like sugar, coconut, copper, banana, and the like. These products are accorded high priorities in fiscal policies because the proprietors are the powerful landed elite. In some concerns like the extractive industries, the proprietors are usually the "new rich" who are political supporters of the prevailing administration. The domestic interest groups also have close ties with foreign interest groups.

These domestic interests have been entrenched for so long that many related economic interests are linked with them. In turn, the economic linkages have formed social structures and institutions. The sugar industry for instance, involves vast areas of agricultural lands planted to sugar, several milling industries, vast networks of railroad transports, shippings and other related interests involving considerable capital technology and labor. The industry has become so interwoven with the economic structure that its promotion and protection demand no less than its high prioritization in development strategies. Thus, the export-orientation of development thrusts whereby fiscal policies see to it that tax incentives, subsidies, low export duties and credit are provided.

In addition, what makes these domestic interest so special to fiscal policies is that they are controlled by those who are in power themselves. As noted above, this peculiar situation reflects the common social structure of developing countries: unequal distribution of wealth and power among social classes.

One domestic interest group which has the potential of becoming powerful is the labor union. It is one of the few domestic groups which might become well-organized and mobilize tremendous resources. The support of labor groups is an important factor in elections. Labor interests generally cover issues concerning compensations and working conditions. These interests are usually expressed when labor groups are involved in special non-voting venues like labor-management dialogues.

Generally, domestic interest groups (or any interest group for that matter) are strongest when they participate in a political process wherein their interests are centrally at stake. Thus, the voter who is also a labor unionist cannot effectively articulate his views in an ordinary election since issues on labor are generally presented. The opposite of course is true where there are political parties known to be intensely pro-labor as the British labor party.

To the Marxist, the labor interest group assumes importance because, under the capitalist system, it is one of the two opposing forces. The strengthening of labor unions in a country is considered an important step towards the victory of the working class. The labor unions are understandably diametrically opposed to the capitalist-employer interest group. However, the labor sector is still disorganized. Labor unions form a very small part of the labor force.

The preceding two domestic interest groups are more visible because they are formally organized. There are interest groups, however, which cannot participate effectively in the political process despite the validity of their interests and demands. An example is the taxpayer group. The taxpayer is an indispensable consideration when fiscal decisions concern taxation. Unfortunately, the taxpayer group cannot effectively express and advance its members' preferences. Under the voting process, the individual taxpayer-voter is limited to casting his vote for an anti-tax or moderate-tax candidate. In special political processes like public tax hearings, his participation is limited in the sense that only the taxpayer who has substantial assets subject to the tax will actually be participating. Thus, the number of affected taxpayers even if they are minimally affected by the tax measure, is not considered. Even existing mechanisms of the political process like small-group decision-making are not adequate to aggregate and reflect the preferences of a diverse and complex interest group such as the taxpayer group.

Only a small minority of taxpayers are in a position to influence tax policy. These are the corporate taxpayers who are represented by their Chambers of Commerce. Majority of the taxpayers who belong to the low income groups have no opportunity to express their preferences.

Because of the disabilities of an interest group like the taxpayer group, the political system is obligated to reach out to them. Thus, tax legislation may be preceded by a series of extensive studies intended to approximate taxpayer preferences. This is one of the non-political mechanisms whereby individual preferences are solicited, clarified, and effectively considered.

C. *The Ideology*

The politics of developing countries is never complete without references to the fact that their political systems invariably tend to be authoritarian. The concentration of political power among a relatively few individuals determines greatly, if not wholly, the direction and substance of fiscal policies. On one hand, fiscal administration is greatly facilitated on the strength of political sponsorship. Hence, some welcome the authoritarianism of decision-making when reforms are formulated and executed with dispatch and force. It is conceded that major institutional and structural changes in developing societies cannot be pursued where there is no strong political process to pursue such. On the other hand, this inequitable distribution or structure of political power is utterly distasteful to some. This sentiment is intensified where the fiscal administration of an authoritarian dispensation is given an opportunity and fails to effectively address the intentions and demands of its avowed development objectives.

Authoritarianism may be the ideology of the entire political process because it determines how efficiently the voting system will reflect the voter's demands and preferences. It governs how the political actors (the voter, the bureaucrat and technocrat, and the lesser politicians) behave under the voting system. In addition, it affects the extent to which the fiscal decisions are executed according to their intents and purposes. In essence, it determines how the fiscal concept of general welfare or the development objectives, through the political process, can become a reality.

III. FISCAL DECISION

To one writer, the translation of individual or group preferences through the political or non-political systems culminates in a budget decision. Thus, fiscal policies and statements should reflect individual preferences over goods and services before the size of the budget is determined; how much of revenues is allocated for production of a certain type of social good or service; how much the citizen has to pay in return for benefits, etc.

If the budget is a representation of the general welfare, its faithful execution can realize the planned social goods and services and thereby maintain and upgrade the general welfare.

While the budget is the essential fiscal end, it is not sufficient for developing countries. Development problems require fiscal tools aside from the budget. Fiscal administration must necessarily go beyond the mere determination of what and how and who pays for social goods and services. In other words, fiscal administration must be related to the development process itself. In addition politics must be part of the development process.

The translation of individual preference through the political process must result to development ends -- economic development, social equity, greater freedom and dignity. Fiscal administration must therefore formulate and execute fiscal plans, strategies and objectives consistent with the development objectives of economic growth, redistribution of income and wealth, balanced socioeconomic development, and economic stability.

Ideally, the process of interaction between politics and fiscal administration should result in development fiscal decisions. For developing countries, the general welfare concept must be a development concept. The identification of the general welfare with development ends is seldom easy and feasible.

A rational political process can result in the identification of the interests of the more powerful elements with the general welfare. But in developing countries the process is warped by the disparity between the powerful and the powerless. Thus, the development process of developing countries is more of a process whereby the powerful and rich classes are able to influence fiscal policy in their favor.

Fiscal administration, particularly policy decisions, takes place within the context of a political framework. Even if the formal political process of fiscal administration is theoretically "democratic," decisions are actually the result of negotiation, bargaining, and compromise. Various groups compete fiercely for a larger slice of the budget pie. Those who are politically powerful -- external groups, bureaucrats, technocrats, local pressure groups -- are in a better position to influence fiscal policy decisions, starting with the fiscal plan, the budget, and even implementation.

In developing countries, the politically powerful are usually in the minority. On the other hand, the politically weak normally belong to the majority. These are the low income groups -- workers, farmers, the urban and rural poor. While labor unions offer the most potential, the labor force is still largely disorganized and fragmented. It therefore has difficulty articulating the interests of the working class.

In the situation described above, it is very easy for the powerful minority to influence fiscal policy decisions in their favor. Government funding and support, and tax and expenditure policies can be made favorable to them. And yet, the entire process can be falsely projected as developmental. Slogans on development, general welfare and so on can cover up for programs which will essentially benefit the powerful minority.

It will take a committed and dedicated political leadership to allocate public resources to the powerless majority. It will take political risk-taking to generate resources from the powerful majority and transfer it to the power-

less minority. These objectives might be very difficult to attain if the formal political process in fiscal policy decision-making is followed. The legislative process, for example, can easily be controlled by pressure groups. Even the implementation of the budget can be reversed or "amended." In such a case, the political leadership, if it is committed enough, can turn to mechanisms outside the system. Budget decisions made by executive order and letters of instructions can avoid the legislative mill. Unfortunately, however, there is always the danger that even these mechanisms will be used to promote the interests of the powerful minority.

Decisions to allocate resources and support to the powerless majority have to be deliberate and conscious. It cannot be left to the normal workings of fiscal politics. It is also necessary for the disadvantaged who belong to the majority to participate in the fiscal administration process. They have to organize themselves and articulate their preferences at every level of the fiscal administration cycle, starting with the national development plan, the annual budget, actual implementation of the budget and on to evaluation. It is only in this manner that their interests can be upheld and protected, and the goals of true development can perhaps be achieved.

CHAPTER 6

TAXATION FOR DEVELOPMENT

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TAXATION FOR DEVELOPMENT

I. THEORY AND PURPOSE OF TAXATION

A. *Definition and Essential Characteristics*

Legally, a tax is "a compulsory contribution from the person to the government to defray the expenses incurred in the common interest of all without reference to special benefits conferred upon taxpayer."[1] Taxation is an important tool which the government employs to keep overall money expenditure for goods and services from advancing or falling too rapidly.[2] It is claimed that the most important aspect of taxation is not the amount of revenue which it produces, but its effect on the level of total money expenditure. Others express more concern on whether it is really promoting equity in the distribution of income and efficiency in the allocation of resources. Both are equally important for developing countries like the Philippines where income disparity is very much a problem and government resources are scarce.[3]

In De Leon's "The Fundamentals of Taxation" (1988) the following features of a tax are cited:

1. It is an enforced contribution;
2. It is generally payable in money;
3. It is proportionate in character;
4. It is levied on persons, properties or transactions;
5. It is levied by the state which has jurisdiction over the person, property or transaction;
6. It is levied by the lawmaking body of the state; and,
7. It is levied for public purpose or purposes.

From the point of view of economics, taxes are classified as follows:[4]

1. Those imposed in the product or factor markets;
2. Those imposed on the seller's or the buyer's side of the market;
3. Those imposed on households or firms; and
4. Those that enter on the sources or uses side of the taxpayer's account.

Musgrave and Musgrave described the above using a matrix.[5] (Refer to Table 6-1 below.) In the product market, with the firm as a seller, he pays retail and value added (consumption type) taxes while the household as a buyer pays expenditure tax. On the other hand, in the factor market, the firm who already acts as a buyer pays value added (income type), employer's payroll, corporate profits and local property taxes while the household who

now acts as a seller of a major factor of production which is labor, pays income (wage and/or capital income) and employee's payroll taxes.

Table 6-1*. Classification of Taxes

	ON FIRM		ON HOUSEHOLD	
Taxes Imposed	As Seller	As Buyer	As Seller (Sources)	As Buyer (Uses)
In Product Market All products	Retail sales tax Value added (Consumption type) (4)	-	-	Expenditure tax (2)
Some products	Cigarette Tax (4)	-	-	Gasoline tax (4)
In Factor Market All factors, all employments	-	Value added (income type) (10)		
Some factors, all employments	-	Employer's payroll tax (11)	Employee's payroll tax (13) Tax on wages capital income (13), (14)	-
Some factors, all some employments	-	Corporate profits tax Local property tax		-

B. *Bases and Purposes*

Literature on taxation tells us that the existence of government (and ultimately that of the state) is a necessity[6] since the state is considered the ultimate socioeconomic and political human organization. In addition, the

state provides the people an apparatus or a machinery where they could cooperate and consolidate their resources for the satisfaction of their common needs. The state supplies an organizational structure for the provision of social (public) goods, like national defense, parks, fire stations and the construction of roads, etc., because no private individual has the incentive to provide them on his own.

The internal and external security provided by the state enables the people to concentrate their energies more on economically productive activities and worry less in protecting their properties from a more powerful neighbor. It is believed that without the state, civilization will be retarded and chaos will result, thus leaving the people at the primitive "survival of the strongest" level. This provides a strong argument for the support of the existence of the state.

Like all other organizations the state needs resources for its operation - specifically for the support of its government. This became one of the justifications for taxation. It is often stated that to justify taxes is to justify the existence of the state itself. In fact, one Supreme Court ruling stated that taxes are the lifeblood of the government,[7] hence, ultimately that of the state.

While most people would not be willing to voluntarily give away and share what they have with others, the state makes the contribution compulsory through taxation. If the contribution is made voluntary, the structure may not work due to the free rider problem. One has no incentive in paying if he knows that he can enjoy whatever services the government will provide without having to pay. If everyone thinks the same way, then nobody will pay at all. The existence (and, consequently, the death) of the state may be gravely compromised.

Through time, the government has been expanding the scope of its services, which now includes housing, water services, insurance and job recruitment. They are now deemed essential to civilized societies, thus giving more opportunities for self- development of the people or for the pursuit of higher non- economic goals.

Taxation for development. Taxation had been used as an instrument of directing the economy of the state to prosperity. More specifically, taxation has been employed to effect equitable distribution of wealth (progressivity of taxation) and to stabilize the economy (inducing savings or investment or employment opportunities).

To developing countries, however, taxation assumes a much more important role - to hasten the economic development of the country. Tax policies and systems are formulated and implemented to support the development thrusts of these countries. Taxation for development is, therefore,

aligned to the strategies for development which include the generation of capital for economic growth, the efficient allocation of resources for balanced socioeconomic growth, and the preservation of the economic independence and self-sufficiency of the country.

Some theories of taxation are useful in determining the ideal tax system in relation to development goals. One of the enduring theories of taxation relevant to a design of a development-oriented tax system is Adam Smith's canons of taxation. Modern theories and principles of taxation revolve around Smith's principles of an ideal tax system: Equity, Certainty, Convenience, and Economy.

1. *Equity* - The principle prescribes that taxes must be based on the taxpayer's ability to pay, as measured by his size of income. Thus, a reasonable classification of the subjects or objects which are to be subjected to a tax must be designed. This permits a determination of a tax differentiation between two taxpayers based upon a relevant difference.[8]

An equitable taxation, as with income tax for instance, should be based not on the ground of height or weight differences, but rather on valid criteria such as size of wealth and income, taking into account the responsibilities and/or disabilities of the taxpayers.[9] Height and weight bears no relevance to the capacity of a person to pay taxes.

The principle of equitable taxation is especially important for societies where income and wealth are unevenly distributed. Its significance is embodied in the policy of states to advance social equity by redistributing income and wealth through tax measures. Among developing countries where the disparities of opportunities are common, this is imperative to achieve the equal allotment of the benefits and efforts of undertaking national development. Among the tax systems and strategies used to achieve such are exemplified by the formulation of a progressive and uniform system of taxation and the efforts to evolve a tax structure characterized by increasing reliance on direct taxes. Thus, equity is achieved when those who have more are taxed more, and the same tax rate applies to subjects in similar situations.

2. *Certainty* - This second criterion specifies that taxpayers should know which taxes are imposed, the amount to pay, and the manner of payment. A taxpayer for example, must be informed whether or not a tax is applicable to him, and if applicable, how much tax he should pay the government and how to pay such. This canon of certainty is necessary in order to avoid overpayment or underpayment of taxes, evasions, or discouragement on the part of the taxpayer to pay.[10]

3. *Convenience* - Smith's third canon takes into account the convenience of the place, time, and manner of payment. This principle demands that the government must locate its collection offices at places where they are easily and conveniently accessible to taxpaying public. Procedures of payment must also be simple and understandable.[11] The practice of automatically withholding taxes on income, for example, is a convenient and effective way of paying income taxes. Likewise, the practice of authorizing banks to collect tax payments is part of the effort to make the payment of taxes convenient.

4. *Economy* - Tax administration according to Smith, must not involve too much expense on the government. If a tax is to be economical, the cost of its collection must be minimal, otherwise the cost of collecting tax will be greater than the revenue realized.

Economy in taxation also means that taxation should not exert negative influences on productive undertakings. Therefore, it should not be too high so as to discourage investment nor too low to permit diseconomies.[12]

C. *Classification of Taxes*[13]

Taxes may be classified according to: purpose, incidence, rate, authority imposing it, object, scope and determination of amount paid.

1. As to *purpose.* A tax may be fiscal, designed solely for raising revenues. It may also be regulatory, intended to achieve social or economic goals regardless of whether revenue is actually raised or not.

2. As to *incidence.* Incidence has reference to the point at which the burden of the tax is actually borne. This is concerned with who bears the burden of the tax. Under this category, tax may be direct or indirect. It is of direct type when the person on whom the tax is imposed absorbs the burden. A classic example of this type is the income tax. On the other hand, a tax is indirect when the charge is paid by a person other than the one on whom it is legally imposed. The latter type is usually levied upon commodities as in value added tax and is practically paid not as a tax but as part of the price of the commodity by the consumers to whom the producer passes on the burden.

3. As to *rate.* A tax may be proportional, progressive or regressive. It is proportional when it is based on a fixed percentage, regardless of the amount of the income or value of property, a single rate being applied to different objects with different values. A tax is progressive when the rate increases as the tax base increases. An example of this is the modern income tax. On the other hand, a tax is regressive when the effective rate decreases as the tax base increases.

4. As to *authority.* A tax may be imposed by the national government as in the case of the income tax, or by the local governments (provincial, city, municipal or barangay) as in the case of the real estate tax.

5. As to *object.* A tax may be charged on personal occupation engaged in by the taxpayers. Usually, a fixed amount is imposed upon all persons of a certain class within the jurisdiction of the taxing power without regard for the value of their property or the occupation. Examples of this are the community tax (formerly the residence tax) and the professionals tax imposed on various professions like medicine, accounting, engineering and the like. In addition, taxes may also be imposed upon property. Property taxes, like the real estate tax, are computed upon a valuation of the property which is assessed either where it is situated or at the owner's domicile. Another kind is the excise tax which is imposed directly by the legislature without assessment, measured by the amount of business done or the extent to which the conferred privileges have been enjoyed or exercised by the taxpayer, irrespective of the nature or value of the taxpayer's assets.

6. As to *scope.* Taxes under this classification may be general or specific. General taxes are those imposed throughout the state for the purpose of financing general public benefits. Special taxes on the other hand, are those levied for a special or local purpose, for the benefit of only a part of the body politic. Examples of special taxes are the Special Fund Tax, the Flood Control Tax, and the Anti-TB Stamp Tax.

7. As to the *amount paid.* An example of this is the specific tax which is paid in fixed amount as appraised by the head or number, or by some standard of weight or measurement. No assessment is required other than a listing or classification of the subject to be taxed. The tax imposed on distilled spirits is an example. The other kind is exemplified by the ad valorem tax in which a fixed value of the property is assessed by appraisers to estimate the value of such property before the amount due can be determined.

II. DEVELOPMENT REQUIREMENTS

A responsive tax system must be able to support and promote a nation's economic and social objectives. For developing countries, this is easier said than done. In a country like the Philippines, taxation (like any other fiscal tool) has to contribute towards realizing the requirements of development, namely, (1) the generation of capital and savings necessary to economic growth; (2) the reduction of inequalities in income and wealth for social justice and equity; (3) the proper allocation and utilization of resources for a balanced development; and (4) the protection of the "exposed" economy from external forces so as to attain stability and unimpeded economic growth.[14]

A. *Capital Formation*

Capital formation is considered the key to economic development. In developing countries, taxation is increasingly assigned the role of generating capital savings in an economy where capital resources are scarce. The scarcity of capital to finance economic growth and production may be traced to the low level of income and savings, and the high propensity for consumption.

In poor countries, taxation must be able to regulate consumption in order to encourage people to save. Likewise, it has to provide incentives to attract the savings into productive investment. More often than not, the capital generated and invested is however not enough. The government steps in to augment capital investment by public spending for the overhead costs of investment as in infrastructure projects for power, transportation, communication, and the like. Thus, it has to borrow or raise more revenues from taxes. Moreover, in the allocation of resources, taxation is used to strike a balance between economic and social development.

In sum, taxation for capital formation should maximize savings, mobilize them for productive socioeconomic investment and provide, where the private sector fails or refuses, the necessary revenues for social and economic infrastructures needed for development.

B. *Allocation of Resources*

Tax measures, through exemptions and incentives, should be able to enhance the efficiency of resource allocation and maximize the benefits of allocated resources such that not only full utilization and productivity for economic growth is achieved but also balanced economic and social development.

Balanced development is achieved through taxation, when incentives and subsidies on economic sectors result in the proper mix of economic and social goods. Hence, taxes which induce the development of the industrial sector towards growth and productivity should be complemented by tax measures which enable the provision of schools, hospitals and other basic social necessities.

An efficient utilization of resource is imperative considering the chronic scarcity of available and actual resources. Taxation can induce economic efficiency through tax measures like subsidies or tax holidays to help ailing industries which promise economic and social benefits. Taxation can also penalize underutilized resources like land through higher taxes in order to induce the full use of such resources.

C. *Redistribution of Income and Wealth*

Among developing countries, the wide disparity in income and wealth among social classes is increasingly becoming an urgent focus of development efforts. In the Philippines, it is the avowed policy of the state to reduce this disparity by the principle of social equity.

Taxation for development requires that the tax system should narrow the gap of resources and opportunities. In addition to the generation of resources to finance public expenditures which provide economic and social opportunities for the less advantaged, tax systems are formulated to exert a direct impact on income inequities and other inequities in the economy. Particularly, revenue administration uses tax strategies which provides tax incentives in underdeveloped sectors of the economy - agriculture for instance - or in lagging areas of the country.

Another is the design of progressive tax structures. A progressive tax system redistributes income and wealth in that it taxes more those who possess greater wealth and income. Hence, more taxes are borne by those who have the ability to bear such burden.

Still another tax strategy is the redirection of the tax structure from indirect to direct taxation. Direct taxes eliminate the indiscriminate shifting of tax burden even to the poor consumer under indirect taxes. Direct taxes like income and property taxes, apportion the tax burden according to the taxpayer's ability to pay. Corollarily, imposing the same amount even on those less advantaged, is avoided.

Finally, when taxes which are raised through a progressive tax structure are channeled towards expenditures which improve the income generating capacities of the disadvantaged, i.e. education, health, employment generating projects, etc., such taxes in the long run contribute to redistribution of income and wealth.

D. *Stability*

A development-oriented tax system must be able to contend with the instabilities of the "exposed" economies of developing countries. An "exposed economy" is essentially that which is highly vulnerable to world market developments which are beyond its control. This exposed position is generally caused by: (1) the heavy dependence of the local economy on the export of its agricultural or mineral products as a source of national income and foreign exchange, (2) dominance of foreign investments in the economy, and (3) the dependence on foreign sources for manufactured products, including oil, machinery, foodstuffs and others not met by local production.

As a fiscal measure for economic stabilization, taxation should be able to: (1) shield the economy from the negative impact of the world market forces in the short-run, (2) promote the diversification of the economy in the long-run. Specifically, taxation should employ a system of tariff controls in order to effectively regulate the flow of export and imports with a view towards balancing the foreign exchange requirements and the competitiveness of some industries; giving the proper incentives and protection to local industries in order to promote the diversification and the self-reliance of the economy; and regulating the economic and financial activities of foreign investors.

Flexible export and import tax administration, along with monetary measures, can be effective in exploiting to the advantage of the local economy sudden shifts in world market prices. It is also a powerful instrument for counteracting the usual high propensity of the economy to import consumer goods.

III. THE PHILIPPINE TAX SYSTEM

With the acceleration of development financing activities of the government, fiscal reforms involving the tax system became imperative. The Philippine tax system underwent radical reforms, both organizational and substantive, in order to align the goals and policies of taxation to national development and to generate more revenues for development projects.

A. *The Constitutional Mandate*

The Constitution contains one basic principle of taxation which embodies the desired correlation of taxation to development goals and strategies.

The Constitution expressly provides that the rule of taxation shall be uniform and equitable and mandates Congress to evolve a progressive system of taxation.[15] A progressive tax system is in consonance with the policy of the State to equitably redistribute income and wealth. To realize this end, the Constitution aims to institute a system of taxation based on direct taxation and a decreasing reliance on indirect taxation. Thus, it is emphasized that the main thrust of tax reforms should be towards improving social equity by a sharp rise in direct taxation and by higher indirect taxation of goods and services consumed by the upper income groups.

B. *The Major Revenue Agencies*

1. **The Department of Finance (DOF)**

The principal fiscal and administrative arm of the government is the Department of Finance.[16] "It is responsible for the judicious and effective

management of the government's tax programs and borrowings to achieve national development goals."[17]

The Department is headed by a Secretary who is a member of the Cabinet. The Secretary is appointed by the President subject to confirmation by the Commission of Appointments. He is an alter ego of the President and is, therefore, serving at the will of the latter. The Secretary of Finance is assisted by five Undersecretaries and also five Assistant Secretaries.[18] Under the present organizational set up, the Department has under it several operating bureaus, which include the Bureau of Internal Revenue (BIR), the Bureau of Customs (BOC), the Bureau of Treasury, and the Securities and Exchange Commission, among others.

2. **The Bureau of Internal Revenue**

a. *Organizational Set Up* (Chart 6-1). The BIR is the premier agency in charge of all matters pertaining to internal national taxation. It is headed by a Commissioner who is assisted by two Deputy Commissioners. For administrative purposes, the Bureau of Internal Revenue is under the executive supervision of the Department of Finance. The Bureau is made up of the following offices: Assessment Service, Collection Service, Excise Tax Service, Special Operations Service, Legal Service, Financial Service, Administrative Service, Planning and Research Service, and, Inspection Service. The first four offices are placed under the Assessment and Collection Group while the rest belong to the Legal and Administrative Group. Each Group is under a Deputy Commissioner. [Refer to the BIR Organizational Chart]

To aid its supervision over collection of national taxes, the BIR maintains regional offices headed by a regional director.[19] At present there are 18 regional offices.[20]

b. *The Powers of the BIR.* In general, the power and duties of the Bureau of the Internal Revenue are the following:

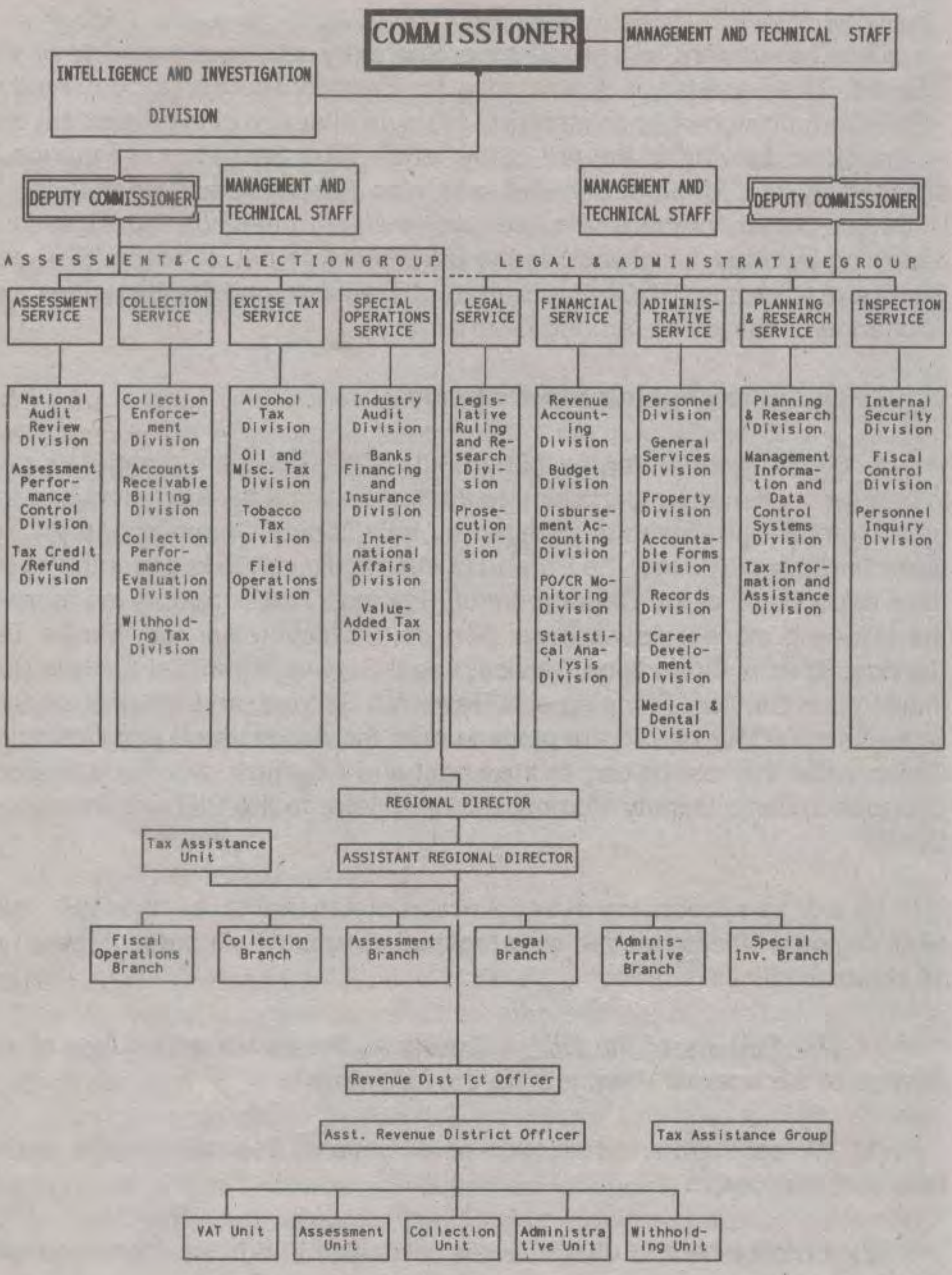
(1) Assessment and collection of all national internal revenue, taxes, fees and charges;[21]

(2) Enforcement of all forfeitures, penalties and fines connected with item 1;[22]

(3) Execution of judgments in all cases decided in its favor by the courts;[23]

(4) Giving effect and administering the supervisory and police power conferred to it by law;[24]

Chart 6-1
BUREAU OF INTERNAL REVENUE ORGANIZATION CHART
EO 127



(5) Recommend to the Secretary of Finance all needful rules and regulations for the enforcement of the provisions of the National Internal Revenue Code;[25] and

(6) And through the Commissioner, the BIR has the following functions: (a) accounting for all revenues collected; (b) exercising all legal requirements that are appropriate; (c) preventing and prosecuting tax evasions and other illegal economic activities; (d) exercising supervision and control over its constituent units; and (e) performing such other functions as may be provided by law.

c. *Taxes Collected by the BIR.* Under Sec. 19 of the National Internal Revenue Code (NIRC), the national internal revenue taxes administered by the Bureau of Internal Revenue are:[26]

(1) Income Tax

(2) Estate and Gift Taxes

(3) Excise Taxes

(4) Taxes on Business

(5) Documentary Stamp Tax

(6) Mining Taxes

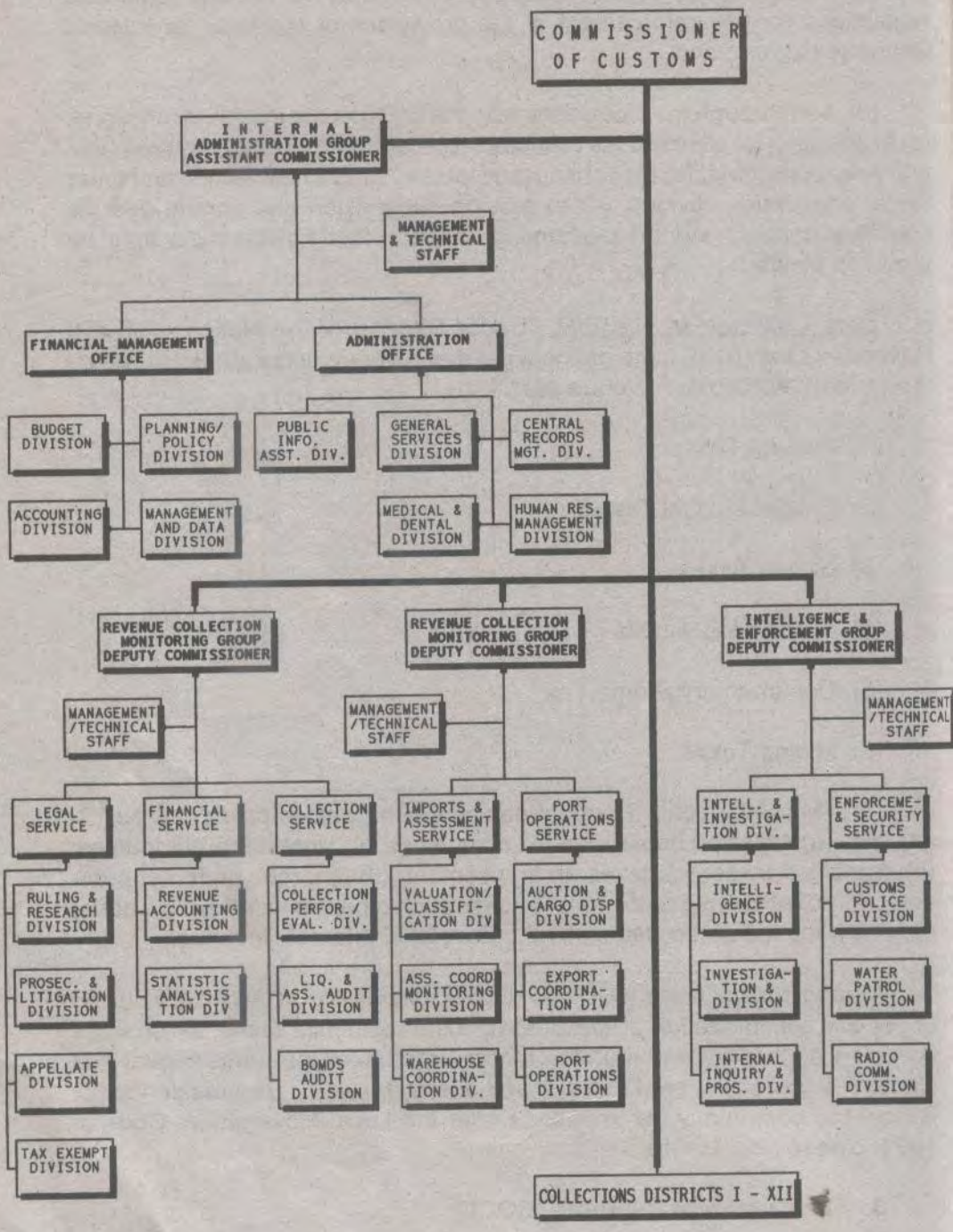
(7) Miscellaneous Taxes, Fees and Charges imposed by NIRC, namely: (a) taxes on banks, finance companies, and insurance companies; (b) franchise taxes; (c) taxes on amusement; (d) charges on forest products; (e) tobacco inspection fees; and (f) such other taxes as are hereafter may be imposed and collected by the Bureau of Internal Revenue.

Among special taxes which by express provisions of laws were placed under the administration of the BIR were the residence taxes, which were collected by the city and municipal treasurers under the former Local Tax Code,[27] sugar adjustment taxes,[28] and energy taxes.[29] The residence tax is now the community tax imposed under the Local Government Code of 1991; please refer to Chapter 8.

3. The Bureau of Customs (BOC)

a. *Organizational Set Up* (Chart6-2). The second major revenue-collection agency of the national government is the Bureau of Customs (BOC); like the BIR, the BOC is placed under the supervision of the Department of Finance. It is headed by a Commissioner. The Deputy Commissioners,

Chart 6-2
BUREAU OF CUSTOMS ORGANIZATION CHART



head and supervise major groups comprising the bureau, namely: Customs Revenue Collection Monitoring Group, Customs Assessment and Operations Coordinating Group, and Intelligence and Enforcement Group, assists the Commissioner.[30]

The chief service offices under the Office of the Commissioner are: Legal and Intelligence Service, Administrative Service, Customs Computer Center, Financial and Management Service, Economics, Intelligence and Investigation Service.

In the interest of efficient management, the BOC apportioned the country into 13 districts, each under the direction of a Collector of Customs.[31] The collector stationed in every port of entry to the Philippines does not only enforce tariff and customs laws but also acts as BIR collector with respect to internal revenue taxes imposed on imported articles.[32]

b. *Powers of the BOC.* Under the Tariff and Customs Code, the BOC is charged with:

(1) Assessment and collection of the lawful revenues from imported articles and all other dues, fees, charges, fines and penalties accruing under the tariff and customs laws;[33]

(2) Prevention and suppression of smuggling and other frauds;[34]

(3) Supervision and control over the entrance and clearance of vessels and aircraft engaged in foreign commerce;[35]

(4) Enforcement of the tariff and customs laws and all other laws, rules and regulations relating to tariff and customs administration;[36]

(5) Supervision and control over the handling of foreign mails arriving in the Philippines, for the purpose of collection of the lawful duty on the dutiable articles thus imported and the prevention of smuggling through the medium of such mails;[37]

(6) Supervision and control over all import and export cargoes, landed or stored in piers, airports, terminal facilities, including container yards and freight stations for the protection of government revenue;[38]

(7) Exclusive jurisdiction over seizure and forfeiture cases under tariff and customs laws;[39]

(8) And the following, through the Commissioner:[40]

(a) Accounting for all customs revenues collected;

(b) Exercising police authority for the enforcement of tariff and customs laws;

(c) Prosecuting smuggling and other illegal activities in all ports under its jurisdiction;

(d) Supervision and control over its constituent units; and

(e) Performing other functions as may be provided by law.

The operations of the Bureau of Customs consist of revenue collection, law enforcement and public service. As to its law enforcement mission, the BOC issues entrance and exit clearance of vessels and aircraft engaged in foreign trade. It regulates the processing of all articles imported into, or exported out of, the Philippines. The BOC oversees warehousing operations, cargo transfer operations, postal clearance operations and customs police operations.[41]

The BOC imposes tariff duties on all articles imported from any foreign country into the Philippines except those provided otherwise by the Tariff and Customs Code.[42] Under the customs law, the BOC is empowered to collect fees, dues and charges for the following:[43]

(a) Each original import or export entry;

(b) Each entry for immediate transportation in bond;

(c) Each original internal revenue entry;

(d) For each original withdrawal entry from any bonded warehouse;

(e) For each bond accepted or received;

(f) For each approval of application in respect to transaction covered by general bond; and

(g) For each Certificate made in the routine administration of the Bureau.

Previously, the BOC had the power to collect harbor fees, wharfage dues, berthing charges, storage charges, arrastre charges and tonnage dues. All these functions[44] are now undertaken by the Philippine Ports Authority under P.D. 857.[45]

C. *Major Philippine Taxes*

In aid of proper understanding of taxation as a developmental tool, it is imperative that we examine more closely how Philippine taxes operate or are imposed.

1. **Income Tax**

As the term indicate, income tax is a tax on all incomes earned by individuals and corporations. Income includes salaries and wages, honoraria and commissions, winnings in gambling and lotteries, dividends, bank interests and profits from business.

It is important to note that among taxes, income tax best approximate the ability-to-pay principle or the progressivity in taxation, because the income of a person or a corporation is the most apparent indication of his/its ability to pay.

Income tax is not imposed on property, hence, the capital assets of a business (property used in business) are not covered. Consequently, even if a business possess millions worth of properties but it does not earn any income, the taxpayer does not have to pay income tax notwithstanding the fact that the properties may be worth more than enough to cover for the business loss. Conversely, a person may have no property at all but, if he wins a lottery, he must pay the income tax.

Corporations and persons are taxed differently, they will be discussed separately.

a. *Income Tax of Individuals.* In levying income tax on a person, the law classifies income into three categories: compensation income, business income, and passive income.

Compensation income refers to earnings from employment, whether regular or casual, and regardless of whether the employer is the government or a private entity. It includes salaries, wages, honoraria, bonuses, pensions, allowances for transportation, representation and entertainment fees. In computing for the tax, all compensation incomes are added to arrive at the gross taxable income of a taxpayer during a particular year. But this is not yet the basis on which the tax payable is computed.

Not the entire income is, however, taxed. Deductions from the gross income are allowed by law pursuant to the constitutional requirement of

progressivity of taxation, the tax code allows some deductions. This is because imposing income tax on everything earned by the taxpayer may leave him without or insufficient resources to fend for himself, thus, killing the proverbial goose that lays the golden egg. The law, therefore, does not tax that part of the income which is spent by the taxpayer for his basic needs. At present, the law allows each taxpayer a P9,000.00 deduction a year, the amount estimated to cover all expenses for his basic needs (food, clothing, shelter, etc.) for that year. This amount may not be realistic because inflation greatly erodes the purchasing power of the peso.

Since not all taxpayers are similarly situated, however, special considerations by way of higher deductions are allowed to those whose ability-to-pay is lessened. To illustrate, consider two husbands who earn the same income, one does not have children while the other has three. To tax them by the same amount may not be equitable because the ability-to-pay of the father who has three children is greatly reduced by an amount equivalent to that he spends for rearing the children. He is, thus, allowed a P4,000.00 deduction for each dependent child. The amount is estimated to cover the expenses of rearing each child during the year. Again, this may not be realistic considering the rising costs of food, clothing, medicines and education. Moreover, the law allows deduction for only three children. While this may not be necessarily equitable, i.e., contrary to the ability-to-pay principle, the purpose is to discourage couples from having more children in consonance with the Philippine population policy.

Another instance is between an unmarried taxpayer who supports several persons and one who has only himself to support. To tax them by the same amount may not be equitable for the ability-to-pay of the former is greatly impaired. Thus, the one who supports other persons is entitled to a P12,000.00 deduction as head of the family, while the other taxpayer can only claim the regular P9,000.00 deduction.

The law treats the husband and wife as one taxable person because the change in their civil status from single to married does not necessarily change the amount they spend for their basic needs, hence, they are still entitled to the basic P9,000.00 deduction each or a total of P18,000.00 for both.

After subtracting all allowable deductions from the gross compensation income, we arrive at the net income. This is now the basis for computing the tax payable. The schedule of the rates is shown in Table 6-2.

Table 6-2. Income tax rates for individuals

Net Income Rate	Rate
P 0 - P 2,499.99	0%
P 2,500 - 4,999.99	1% of excess over P 2,500
P 5,000 - 9,999.99	P 25 + 3% of excess over P 5,000
P 10,000 - 19,999.99	P 175+ 7% of excess over P 10,000
P 20,000 - 39,999.99	P 875 + 7% of excess over P20,000
P 40,000 - 59,999.99	P 3,075 + 15% of excess over P40,000
P 60,000 - 99,999.99	P 6,075 + 19% of excess over P60,000
P 100,000 - 249,999.99	P 13,675 + 25% of excess over P100,000
P 250,000 - 499,999.99	P 49,675 + 29% of excess over P250,000
P 500,000 and above	P122,175 + 35% of excess over P500,000

As may be observed in Table 6-2, the tax rates increase as the income brackets go higher; this is reflective of the constitutional mandate for progressivity of taxation. The apparent purpose is to spread the burden of taxation equitably among persons with different financial resources. The higher the income bracket the greater the portion of that income goes to taxes. While this arrangement is equitable, it may discourage people from earning more compensation income, and induce them to obtain business income, instead (see discussion below) to take advantage of more generous deductions.

The second type is business income which refers to profits from business operations. While the tax rate is the same as in compensation income, the law, however, allows more deduction advantages to business incomes. The theory is that in earning business income, overhead expenses are necessarily incurred, like advertising, purchases of tools and machineries, payment of salaries/wages of employees. The wage/salary earner on the other hand, according to this theory, does not incur these expenses in order to earn the salary or wage. Consequently only business income earners are

allowed to deduct expenses incurred to generate profits. These deductions are:[46]

(1) Business expenses;
(2) Interests paid on indebtedness;
(3) Taxes, except certain taxes like income tax;
(4) Losses to the extent which is not compensated for by insurance or otherwise
(5) Bad debts;
(6) Depreciation of property;
(7) Depletion of natural resources, like mines and gas wells
(8) Charitable and other contributions;
(9) Pension trust contributions of employees;
(10) Personal exemptions allowable to individuals.

The taxpayer is required to support the expenses claimed as deductions with receipts, etc. However, instead of the laborious process of preparing voluminous receipts and other supporting documents, the taxpayer may choose to avail of the 10% optional standard deduction computed on the gross income. The amount is presumed to be equivalent to the taxpayer's average expenses in earning profit.

It is contended, however, that this scheme gives undue advantage in favor of business income earners vis-a-vis salaried workers. It is alleged that there is no substantial distinction between salaried and business income earners because salaried employees also incur expenses analogous to overhead costs, like good education, personal improvements, among others.

Passive incomes refer to royalties, prizes worth over P3,000, other kinds of winnings and interests of bank deposits, inter alia. Unlike compensation and business incomes, passive incomes are not subject to a graduated tax rates schedule. A fixed rate of income tax is imposed regardless of the amount of the income (except that of prizes). Consequently, when during a particular year a person earns compensation, business and passive incomes, he shall lump together business and compensation income in computing income tax; the passive income is taxed separately.

b. *Corporate Income Tax.* Corporations, for purposes of income taxation also refer to partnerships, joint accounts, associations and insurance companies. Since they are primarily established for making profits, corporations are taxed in the same manner as an individual who earns income solely from *business.* Corporations are, however, not entitled to personal deductions clearly because all its operating expenses are necessarily business expenses which are covered by itemized deductions. Individuals, on the other hand, are entitled to personal deductions to cover expenses which are necessary for their existence (food, clothing and shelter) but not essential

for the operation of their business. Corporations pay a uniform rate of 35% on net income.

It is apparent that the rate is comparably higher than that of an individual. The reason for the difference is that corporations, unlike individuals, exist primarily for generation of profit. This is not to discourage the creation of corporations but based on the theory that corporations are primarily profit oriented and their being necessarily possessed with business assets make them more financially capable to pay the tax in contrast to an individual who has to spend much of his earnings to non-income generating, though necessary, expenses.

Since not all corporations are created for profit, some of them are exempt from income tax. They are:[47]

(1) Labor, agricultural or horticultural organization not organized for profit;

(2) Mutual savings bank not having capital stock represented by shares, and cooperative bank without capital stock organized and operated for mutual purposes and without profit;

(3) Fraternal beneficiary society, order or association, operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under a lodge system and providing for the payment of life, sickness, accident, or other benefits to the members of such society, order, or association, or their dependents;

(4) Cemetery company owned and operated exclusively for the benefit of its members;

(5) Corporation or association organized and operated exclusively for religious, charitable, scientific, athletic, or cultural purposes, or for the rehabilitation of veterans, no part of the net income of which inures to the benefit of any private stockholder or individual;

(6) Business league, chamber of commerce, or board of trade, not organized for profit and no part of the net income of which inures to the benefit of any private stockholder or individual;

(7) Civic league or organization not organized for profit but operated exclusively for the promotion of social welfare;

(8) Club organized and operated exclusively for pleasure, for recreation, and other non- profitable purposes, no part of the net income of which inures to the benefit of any stockholder or member;

(9) Farmers' or other mutual typhoon or fire insurance company, mutual ditch or irrigation company, mutual or cooperative telephone company , or like organization of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting its expenses;

(10) Farmers', fruit growers', or like associations organized and operated as a sales agent for the purpose of marketing the products of its members and turning back to them the proceeds of the sales, less the necessary selling expenses, on the basis of the quantity of produce finished by them;

(11) Corporation or association organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the extra amount thereof less expenses, to an organization which is itself exempt from the tax imposed by this Title;

(12) Government educational institution.

2. Transfer Taxes

Gratuitous transfer of properties is also taxed. It is called estate tax if the property passes to another by inheritance and gift tax if transferred through donation. There are several reasons for the imposition of transfer taxes:[48]

a. "Society may wish to limit a person's right to acquire wealth by way of bequests, i.e., 'without own effort.' Rugged individualism may be taken to call for this solution, with equal positions on the 'starting gate' and open to inequalities that follow."

b. "Society may have the more general objective of achieving more equal distribution of wealth. The institution of inheritance is one of the major factors making for concentration of wealth, with inherited wealth accounting for half or more of the net worth of every wealthy man and for most of the net worth of equally wealthy woman." Estate tax "may thus be used to moderate inequality in the distribution of wealth."

c. A transfer tax "may be viewed as a supplement to income taxation, rather than as an additional tax on transfer." While donations and inheritances have the same effect with income of increasing the wealth of a person, income tax does not capture them because they are not earned only given. Because no effort is exerted to receive donations and inheritances their tax rates are much higher than those of income tax.

d. In estate tax "society may wish to limit a person's right to dispose of his or her property at death. Society says to individuals that they may use their property during their lifetime, but that their title ceases or is curtailed at death."

e. Also in estate taxation, "society may wish to place increasing limitations on a person's right to pass on wealth as subsequent generations are reached."

The law considers estate tax as "technically a tax on the privilege to transmit property upon one's death."[49] Philippine jurisprudence recognizes three reasons for the imposition of estate tax. The primary purpose is revenue generation, which has been extensively discussed already. The second is

> *"to limit fortunes by taxation. x x x Big estates pay more taxes for they belong to higher brackets, thus lessening the shares of the heirs in the estate and enabling the Government to participate in the inheritance under the philosophy that the State is a continuing partner in ownership of property within its domain. This is so because the State recognizes that ownership and protects it against invasion of rights by others. It is but just that in view of State protection to the owner of the property, when such owner dies, the State should participate to some extent in the form of estate taxes."*[50]

The third is

> *"to attain, as much as possible, equitable distribution of wealth x x x because the Government uses the estate taxes for public purposes like building of tenement houses for the poor, the latter thus indirectly participate in the inheritance. Consequently, the people as a whole become beneficiaries of the estate taxes."*[51]

Estate tax is computed based on the value of all properties owned by the deceased at the time of his death. It is technically an obligation of the deceased, and is paid by the administrator of his estate by selling some properties of the estate. If the properties of the deceased are distributed to the heirs without payment of estate taxes, each heir is liable for the tax proportionately.

It is not, however, the entire estate which is taxed. The law allows deductions, like, funeral expenses, judicial expenses for testate or intestate proceedings, debts of the estate, unpaid mortgages, bad debts, taxes owed by the deceased, losses incurred during the settlement of the estate, property

previously taxed, properties given for public purposes and the first P1,000.00 of the estate.

The rates shown in Table 6-3, is graduated, hence, reflects the ability-to-pay principle.

Table 6-3. Estate Tax Rates

Value of the Net Estate	Tax
P 0 - 9,999.99	Exempt
P 10,000 - 49,999.99	3% of excess over P 10,000
P 50,000 - 74,999.99	P 1,200 + 4% of excess over P 50,000
P 75,000 - 99,999.99	P 2,200 + 5% of excess over P75,000
P 100,000 - 149,999.99	P 3,450 + 10% of excess over P100,000
P 150,000 - 199,999.99	P 8,450 + 15% of excess over P150,000
P 200,000 - 299,999.99	P15,950 + 20% of excess over P200,000
P 300,000 - 399,999.99	P35,950 + 25% of excess over P300,000
P 400,000 - 499,999.99	P60,950 + 30% of excess over P400,000
P 500,000 - 624,999.99	P90,950 + 35% of excess over P500,000
P 625,000 - 749,999.99	P134,700 + 40% of excess over P625,000
P 750,000 - 874,999.99	P184,700 + 45% of excess over P750,000
P 875,000 - 999,999.99	P240,950 + 50% of excess over P875,000
P1 M - 1,999,999.99	P303,450 + 53% of excess over P1 M
P2 M - 2,999,999.99	P833,450 + 56% of excess over P2 M
P3 M and above	P1,393,450 + 60% of excess over P3 M

Donor's tax, on the other hand, is imposed on the donor for transmitting property to another during his lifetime. The phrase "during his lifetime" distinguishes donor's tax from estate tax which has higher tax rates. Observed by Dean Vitug,

> *"The gift tax rates are comparatively lower than the counterpart rates in estate taxation that may thus provide an incentive for taxpayers to opt for the less onerous tax. On the part of the government, the reduction in revenue could well be made up by an earlier payment of the transfer tax (See Report of the Tax Commission on National Internal Revenue Laws, Vol. I, p. 63.)"*[52]

The basic purpose of the donor's tax, according to Commissioner Nolledo is,

"to prevent the avoidance of estate tax through lifetime transfers of property which property would otherwise transfer by will or through the death of the owner. Thus, according to the U.S. Supreme Court in Harris vs. Commission (340 U.S. 106, 1950), the purpose of the gift tax is to complement the estate tax by preventing the tax-free depletion of the transferor's estate during his lifetime."[53]

The schedule of the rates is shown in Table 6-4.

Chart 6-4. Donor's Tax Rates

Value of the Gift	Tax
P 0 - 999.99	Exempt
P 1,000 - 49,999.99	1.5% of excess over P1,000
P 50,000 - 74,999.99	P 735 + 2.5 % of excess over P50,000
P 75,000 - 99,999.99	P 1,360 + 3% of excess over P75,000
P 100,000 - 149,999.99	P 2,110 + 6% of excess over P100,000
P 150,000 - 199,999.99	P 5,110 + 9% of excess over P150,000
P 200,000 - 299,999.99	P 9,610 + 12% of excess over P200,000
P 300,000 - 399,999.99	P 21,610 + 15% of excess over P300,000
P 400,000 - 499,999.99	P 36,610 + 18% of excess over P400,000
P 500,000 - 624,999.99	P 54,610 + 21% of excess over P500,000
P 625,000 - 749,999.99	P 80,860 + 24% of excess over P625,000
P 750,000 - 874,999.99	P110,860 + 28% of excess over P750,000
P 875,000 - 999,999.99	P145,860 + 32% of excess over P875,000
P1 M - 1,999,999.99	P185,860 + 36% of excess over P1 M
P2 M - 2,999,999.99	P545,860 + 38% of excess over P2 M
P3 M and above	P 925,860 + 40% of excess over P3 M

3. Value Added Tax

This is a tax on the privilege of selling merchandise and of importation. Unless excepted or considered zero- rated by law, VAT is imposed as 10 % of the value of the goods sold or imported. It replaced the multi-tiered rate structure of the sales tax. An extensive discussion on this is found at the later part of this Chapter under the Post- EDSA Revolution Reforms.

4. Customs Duties

Customs duties are levied on the exportation and importation of goods. "All imported articles, when imported from any foreign country into the Philippines are subject to duty upon each importation, even through pre-

viously exported from the Philippines."[54] However, pursuant to EO 26 export taxes are no longer imposed except on logs, obviously to discourage logging which have caused irreparable damage to the communities in the form of flash floods and landslides.

Duties are imposed not only to raise revenues but more significantly to implement the economic and even political policies of the state. Thus, if the state does not want the entry of particular goods from another country, either as a form of economic or political pressure, it can impose a prohibitive rates on them. On the other hand, if the state, would like to discourage the export of certain goods, like for the purpose of preventing the depletion of natural resources of the country, the government may impose high export taxes.

There are several kinds of customs duties. Ad valorem customs duty is based on the market value or price of the imported article.[55] Specific customs duties are those based on the weight or volume of the imported articles.[56] Alternate customs duties are based either on the weight or volume or on the value of the imported article whichever is higher, while compound duties are based both on the weight or volume and the value of the imported article.[57]

In addition, special customs duties are also collected.

a. A dumping duty is "imposed on a specific kind or class of foreign article which is being imported into, or sold or is likely to be sold for exportation to or in the Philippines, at a price less than the fair value, the importation or sale of which might injure, retard the establishment of, or is likely to injure an industry producing like goods in the Philippines."[58]

b. A countervailing duty is imposed on articles, upon the production, manufacture or export of which x x x subsidy is, directly or indirectly, granted in the country of origin and/or exportation. It is not required that there be proofs that the importation caused damage to domestic industries producing the same commodities.[59]

c. A marking duty is imposed on articles or their containers which have not been properly marked in any official language of the Philippines as to indicate the name of the country or origin on the article. The purpose is to prevent deception of consumers.[60]

d. A retaliatory or discriminatory duty is imposed on articles of a foreign country which discriminates against Philippine commerce in such a manner as to place it at a disadvantage compared with the commerce of another foreign country. Here, the amount may be increased in an amount not exceeding 100% ad valorem when the President finds that the public interest

will be served thereby. In case of continued discrimination, the articles coming from such foreign country may be banned."[61]

5. Local Taxes

Under the Local Government Code pursuant to the mandate of the Constitution, local government units are empowered to levy a variety of taxes and other fees. They are substantially discussed in Chapter 8.

6. Real Property Taxes

The real property tax is assessed on real properties located within the territory of a local government unit in proportion to its value or in accordance with some other reasonable method of apportionment.[62] Real properties include lands and buildings. Under Philippine jurisprudence, however, it is levied not necessarily on the registered owner of the property but on the one who actually uses it, like the lessee. Thus, even if the law exempts the owner from paying the real property tax, the actual possessor may still be compelled to pay the tax. Conversely, if the registered owner is not exempt from paying the tax, the actual user may still be tax exempt, like if the government leases a private property. More extensive discussion may be found in Chapter 8.

7. Exemption and Taxation

Tax exemption is the grant of immunity to particular persons or corporations from tax. There are two grounds for grant of exemptions: contract and reason of public policy.

When based on contract, the exemption to tax will be binding upon succeeding legislatures because the latter has become a party to it.[63] This is so because when the state enters into a contract it divests itself of sovereign personality and assumes the character of an ordinary corporation. In acting like any ordinary person, the state is bound by the stipulations of the contract notwithstanding subsequent passage of laws to the contrary. Otherwise the laws would be declared unconstitutional, in violation of Article III Section 10 of the Constitution - "No law impairing the obligation of contracts shall be passed." A good example of this is the case cited in the book of Justice Cruz:

> *In Casanova v. Hord,[64] the Spanish Government, in exchange for certain obligations assumed by the plaintiff, deeded to him certain mines in accordance with the Royal Decree of May 14, 1867, which inter alia imposed a number of taxes on the said mines and further provided that "no other taxes than these herein mentioned shall be imposed." When pursuant to subsequent law the Bureau*

of Internal Revenue later sought to collect additional taxes from these mines, the Supreme Court declared: "It seems very clear to us that this deed constituted a contract between the Spanish Government and the plaintiff, the obligation of which contract was impaired by the enactment of Section 134 of the Internal Revenue Law above cited, thereby infringing" the impairment clause.[65]

Exemption from taxation founded on public policy are granted to encourage or favor special subjects or interests. Unlike exemption arising from contract, the second kind is extended gratuitously or without valuable consideration. This being so, the state may "validly [revoke it] at will, with or without cause. Thus, if the legislature grants a tax exemption to new and necessary industries for a period of ten years, it is not inhibited from withdrawing the grant even before the end of the prescribed period."[66]

Because tax exemption laws are impressed with national interest, special rules are applied in interpreting them. It includes a well-settled principle that a special privilege or exemption claimed under a statute, charter, or articles of incorporation is construed strictly against the taxpayer and in favor of the government. This is because exemptions reduce government revenues, which if allowed unrestricted may deprive the government of much-needed revenues essential to development. Ideally, the loss of revenue from the grant of exemptions must approximate the gains. In practice, however, some governmental goals sought to be achieved by way of tax exemptions are incapable of being measured in monetary terms. An example of this is the grant of property tax exemption on religious sects. While the tax foregone by the state may amount to billions of pesos, the role played by the churches in shaping the morality of the people cannot be quantified in money. Thus, the problem of the cost-benefit analysis of tax exemption remains a reality.

As part of Philippine fiscal policy geared towards economic development, tax exemptions is seen as a good incentive for foreign investors. The recent history, however, reveals an uncomfortable situation for the government, needing badly both foreign investments and government revenues as essential to economic development. Thus, we see a never-ending cycle of granting and withdrawal of exemptions. For instance, during the Marcos years, PD's 1931 and 1955 were passed withdrawing tax exemptions of all government and private entities, but at the same time the Fiscal Incentives Review Board (FIRB) was created to restore some exemptions in line with the existing fiscal policies. In due time, the exemptions proliferated not only because of FIRB restorations but also through enactment or reenactment of laws or PD's granting new tax privileges and restoring previously withdrawn exemptions. In line with the consolidated government effort to attract foreign investors, the government allowed more tax exemptions under the law of the Board of Investments (BOI). When the Aquino administration came into

power, it found tax exemptions no longer responsive to the development goals of the new government. Consequently, President Aquino issued EO 93, inter alia, withdrawing all tax exemptions granted to both private and government entities. Again the FIRB was tasked to restore privileges in line with the current fiscal policies. However, upon the convening of the Congress, FIRB lost the power to restore exemptions in view of the Constitutional provision that only Congress may grant tax exemptions. At present, tax exemptions gradually proliferate, and if the trend continues another round of withdrawal of tax exemptions in the near future may be expected.

As regards government entities, however, extra government time and effort are incurred by their non- exemption from payment of taxes. Instead of outright exemption, they are given or allotted in their respective budgets items for payment of taxes. In short, they pay taxes from their budget. While this may sound like transferring fund from one pocket to another, the purpose is the implementation of the government policy of transparency. While previously no one knows how much money is forgone by the government through exemptions of government entities, the present system provides a more or less precise amount of revenues lost, for they are reflected in the budget.

Exemptions to these rules may be on the policy of liberal construction - when the exemption relates to special cases and affecting only special classes of persons or when the property taxes is for religious, charitable, and/or educational purposes.

In the study of Yoingco and Sy,[67] part of the 1986 Tax Reform was the replacement of major tax and duty exemption provisions by a system of direct outlays/appropriations effective July 1, 1986. Unlike outright exemption, direct outlays/appropriations is programmed on the basis of actual needs/requests of affected enterprises, hence, it may even be a stronger attraction for investment initiatives. Because direct outlays/ appropriations approximate the real necessities, "the role of the government in sharing the real risk and cost associated with a promoted activity is highlighted" which effort is not comparatively apparent in the provision of outright exemption. Moreover, this system provides the government the "desired level of discipline and control over its financial resources." This is so because this can be availed of only through budgetary proceedings, i.e., the beneficiary justifies this government assistance like any government expenditures.

Interestingly, there are exceptions to taxability:

a. Incentives granted to Board of Investments (BOI)- promoted enterprises under BP 391;

b. Incentives granted to Export Processing Zone Authority (EPZA)-promoted enterprises under PD 66, as amended;

c. Incentives arising out of international agreements to which the Philippines is a signatory;

d. Incentives protected by the non-impairment clause of the Constitution;

e. Incentives granted under the four basic tax codes (National Internal Revenue Code, Tariff and Customs Code, Real Property Tax Code and Local Tax Code);

f. Suspension of taxes and duties due from distressed copper mines under LOI 1416.

Although policy makers recognize that non-fiscal incentives "respond more directly to an actual industry need/problem" they failed to take into account the system of non-fiscal incentives, like marketing, production and credit.

In the case of "location investment decisions" these being solely dependent on fiscal incentives is misleading since host of other factors like provisions of infrastructures, accessibility of raw materials, availability of cheap but skilled labor, power and water also matter.

IV. RECENT DEVELOPMENTS

A. *Developments Under the Martial Law Regime*

1. **Organizational Reforms**

Presidential Decree (PD) No. 1 issued under the New Society enjoined major revenue agencies to gear their efforts towards development objectives.[68] The Decree updated and streamlined the operation of tax collection agencies. It also provided for a new staffing pattern, intensified and expanded tax functions, abolished obsolete divisions, and streamlined the agency functions into two major functional areas - one for administration and another for operations.

Personnel reforms were directed towards the separation of unfit and erring employees from the service, the adoption of a new staffing pattern with higher salary scales, and the adoption of an intensified training program. New recruits were taken in to augment the existing staff and to enable the personnel system to cope with the increasing magnitude of its new functions and responsibilities.[69]

The tax and revenue collection agencies of the government were the first to undergo restructuring. Because of their important role in providing logistical support to government's expanded functions and financing requirements, the BIR and the BOC were reorganized. In the past, these offices have been invariably subjected to political interference in matters of policy as well as operations. Employee morale was low, and graft and corruption were rampant. Both bureau were overstaffed and some of their units were duplicating each other's functions. Furthermore, the bureaus were performing functions beyond their basic tasks of tax assessment and collection.[70]

At the Bureau of Customs, some of the innovations in the staffing patterns were: (1) the creation of the Tax Exempt Division to pass upon importation of BOI-registered firms and other tax exempt industries; (2) the integration of the national customs police; (3) the installation of a computer system to monitor processing of documents and assignments; and (4) the streamlining of the Manila International Airport operations.[71]

The creation of industry group audit teams in the BIR facilitated investigation of tax returns through the so- called package audit system. Under the system, the various types of returns of a taxpayer are investigated simultaneously only once a year. Formerly, each type of tax return was audited singly and independently without regard to the taxpayer's other types of tax returns. This practice caused constant irritants between the tax authorities and the taxpayer and also provided opportunities for harassment, negotiation and manipulation.[72]

The package audit system which prescribes an annual audit minimized these problems. At the same time, it ensured the investigation of all facets of the taxpayer's business and, therefore, brings about the discovery of interrelated transactions. The latter may be resorted to as a means of reducing tax liability through shifting of income and unfounded claims for deductions of new ones.

The BIR launched a positive recruitment program for operational positions to augment and reinforce the existing staff which was earlier reduced by the separation of unfit and erring personnel. Some specific major changes introduced in the Bureau of Internal Revenue included:[73] (1) the creation of the special audit teams by industry group; (2) the conversion of the tax fraud unit to a division; (3) creation of the Tax Incentive Division to facilitate the processing of the tax exempt industries; (4) the elevation of the Data Processing Center into a department to provide an integrated system of data collection and information for policy making and effective tax administration; (5) the creation of revenue attache positions; and (6) the reduction of the number of regional offices.

It was observed that the Bureau's activities heavily concentrated on the review, investigation or audit tax returns, after they have been filed. Few efforts were exerted towards checking the tax laws and seeing to it that the taxpayers are notified about their liabilities before deadlines. In order to correct this, the BIR put more emphasis on increasing the number of taxpayers on the basis of voluntary compliance. It became the duty and obligation of tax administrators to see to it that the taxpayers within their jurisdiction are properly identified and their tax returns are monitored.[74] In line with this development, the Bureau adopted new procedures in handling taxpayer records and in monitoring information. Every revenue district officer was required to establish a system whereby he can identify, within his area of jurisdiction, taxpayers who failed to file returns. Thus he could encourage them to pay their liabilities even before deadlines for their payment. Other innovations included the proper monitoring of tax compliance with the following:[75]

a. Taxpayers subject to the withholding tax were to be determined and identified. Every revenue district office was furnished by the Withholding Tax Division with the list of those taxpayers who were subject to withholding on their salaries and wages.

b. Remittance of taxes withheld at source by withholding agent were monitored. The utilization of the data bank was also introduced, encouraging voluntary compliance. At the same time, it served as a means of detecting non-filers and non-payers of taxes due and as a source of information vital to the determination of taxpayer's liabilities. This was made a standard operating procedure before any tax audit or investigation of a taxpayer was undertaken.

2. Substantive Reforms

Aside from organizational and procedural innovations in the major revenue raising agencies of the government, there were substantive reforms introduced on the strength of the reform momentum of the Martial Law. These reforms included the revision of the Tariff and Customs Code (P.D. No. 34), and of the National Internal Revenue Code (P.D. No. 69).

In order to ensure more efficient revenue administration procedures and systems, several innovations were introduced. Among the more significant were the grant of a series of tax amnesties, the revision and codification of customs laws, the property tax reforms, and the tax measures to increase revenues.

a. *Tax Amnesties.*

Under PD 23, as amended by PD's 67, 156, and 157, there was an imposition of 10% tax on all previously untaxed income or wealth. Paragraph 1 (c) of PD 67 required the previously untaxed income hoarded abroad must be repatriated and deposited with any bank in the Philippines or invested in government bonds, securities, or debentures, notes or other commercial papers issued by domestic corporations or any productive enterprise within six months from the time of such disclosure. This resulted in collection of P776,057,925.09 from 194,778 amnesty seekers.[76] Other tax amnesty decrees were:[77] PD 52, for possessors of untaxed motor vehicles; PD 53 (amended by PD 80), for possessors, owners or imports of untaxed or undertaxed imported goods in commercial quantities; and PD 68, which condoned delinquent tax accounts and tax amnesty or contested assessments. The total collections generated under these decrees totaled to P24,911,447.95, although this was reported to be only partial. It was noted that collections under PD 157 alone amounted to P23,774,159.96.[78]

There were two latest Presidential Decrees on Tax Amnesty: PD 1740 and PD 1840. Under PD 1740, the amnesty was extended to resident and non-resident citizens, resident aliens, estates and trusts, who fail to file income tax returns, and who filed erroneous false or fraudulent returns for any of the taxable years from 1974 to 1979. The amnesty provided immunity of taxpayers from civil and criminal penalties imposed under the National Internal Revenue Code. Likewise, the Commissioner of Internal Revenue or his representatives were prohibited from conducting investigation on the amnesty return filed, except under lawful order of the court. The immunity, however, does not apply if the amnesty tax paid was less than the tax percentages required by Revenue Regulation No. 1781.[79]

Under PD 1840, there was grant of full tax amnesty on previously untaxed income earned between 1974 and 1980. The decree granted amnesty to residents, citizens or aliens upon payment of 20 percent tax. In the case of non-resident citizens who earned income abroad, the tax was 2 percent, converted into US dollars. It provided that payment of the amnesty tax would terminate all cases whether pending investigation or being litigated by the BIR or other agencies of the government. Those who have already availed of the benefits granted under PD 1740 and its implementing regulations were also eligible to the benefits by PD 1840 and allowed to credit any amount previously paid under PD 1740 against the amnesty tax payable under the later decree.[80]

b. *Revision of the Tariff and Customs Code.*

The revised Customs Code simplified the system of classification and structure rates. It reduced the number of classification as well as the rates to be applied on them. This resulted in the lessening of conflicts, thereby facilitating effective administration. Further, the Code reduced the catch-all

category of "others" which was vague and which provided room for evasion of taxes with higher rates applicable to specific categories. This resulted in the reduction of opportunity for graft which entailed heavy losses of potential tariff revenue to the government.[81]

c. *Real Property Tax Developments.*

A number of decrees were passed to improve the system of taxation on real properties. P.D. 76 provided the filing of taxpayers of self-assessed value of their lands and other real properties to enable the government to get an updated listing of property and its current market value.

An interesting innovation was the introduction of some progressivity in real property taxation by providing graduated levels of assessment relative to current and fair market value.[82]

P.D. No. 464 codified existing real property tax laws. Another significant decree was P.D. No. 231 which provided for more taxing powers for local governments. (See more discussion on this in Chapter 8, Financing Local Governments).

d. *Measures to increase revenue and improve tax systems.*

(1) Tax measures to increase revenues include:[83] amendment of Sec. 192 (3) of the NIRC on dealers of gasoline and petroleum products (PD 1671, February 7, 1980); and of Sec. 193 of the NIRC on: increasing the rates of specific tax on petroleum products (PD 1671, February 7, 1980); imposition on tax on motor vehicles with air conditioning units (PD 1686, March 16, 1980); surtax on extraordinary gains realized by oil companies on petroleum products (PD 1709, August 13, 1980); increase in specific tax on distilled wines and compound liquors (PD 81, September 17, 1980) and on cigarettes except in cases on those packed in 30's (BP 81, Sept. 17, 1980); amendments of the provisions on taxation of forest products (BP 83, September 17, 1980) and on taxation of minerals and mineral products (BP 84, September 19, 1980).

(2) Tax measures to improve tax administration and enforcement comprehended declaration of the Banking Industry as indispensable to the growth of the National Economy (PD 1737, September 17, 1980) and those contained in the omnibus amendment to the NIRC (PD 1705 March 19, 1980);

(3) Tax measures for promotion of investments and achievement of equity in taxation comprised: provision for computation of internal revenue allotments to local governments (PD 1741, October 31, 1980); support for sugar businessmen in the form of exemption from payment of customs and

tariff duties, special import tax compensating tax covering importation of sugar mills machinery, spare parts and equipment for a limited period (PD 1910, August 13, 1980); amendment of several sections of the NIRC on petroleum organizations (PD 1682, February 1980); granting fiscal incentives under PD 1739 (September 17, 1980); condoning penalties of certain violations of the Income Tax Law upon voluntary disclosure of income tax purposes and requiring periodic submission of net worth statement (PD 1740, October 31, 1980).

e. *Gross Income Taxation (GIT)*[84]

A very significant reform in tax system, gross income was embodied in the Batas Pambansa (BP) 135, otherwise known as the Modified Gross Income Tax Law. The new tax scheme departed from the old system of the net income taxation by adopting a new tax concept based on the schedular approach; incomes from different sources are taxed at different schedules.

Personal income taxe before 1981 was global, i.e., compensation, business/professional and passive incomes were treated uniformly. That became schedular, with the effectivity of BP 135 (Modified Gross Income Tax Law) and PD 1800 (Instituted Final Withholding Tax on Passive Income) in 1981. Under that tax system the three income types were administered differently.

Under the gross taxation scheme, personal incomes are classified into three categories:

(1) **Category I** - *Compensation Income*

Under this category are included those incomes gained from employment such as salaries, wages, compensation, emoluments and honoraria; bonuses; allowances; non-monetary compensation; fees (including director's fees and the like); taxable pensions; amounts drawn as salaries by partners of partnerships taxable as corporations; commissions; and other incomes of a similar nature.

With this categorization, most of the exemptions and allowable deductions of the net income system were eliminated. Under the GIT, only personal and additional deductions are allowed because deductions are already built into the relatively lower tax votes. The applicable rate schedule under this category is the same as the present.

Personal and additional exemptions were provided under the tax scheme: P3,000 for single, P4,500 for head of the family, and P6,000 for married taxpayers. P2,000 deduction was allowed for each dependent not exceeding four.

These exemptions were provided for under PD 1773 but were retained with the implementation of the new tax scheme. Likewise, the indexation scheme provided under the same Decree was retained. Under the GIT scheme, an adjustment for the levels of personal and additional exemptions may be done by the President every three years upon the recommendation of the Minister (now Secretary) of Finance and after taking into consideration certain variables such as consumer price indices, level of minimum wages and others.

(2) **Category II** - *Business Income and Income from Profession*

Incomes included under this category are business incomes and/or trade incomes; fees for the exercise of profession, gains from sale of exchange of capital assets (except gains arising from sale of real property under BP 37) and gains from stock transaction; rental incomes; and all other incomes not covered by Category I.

Deductions under this category include expenses which are incurred in connection with trade, profession or business such as ordinary and necessary expenses connected with profession or business, interest, losses, payment to pension trust, depreciation, depletion, taxes, bad debts, and charitable contributions, which, whether or not connected with trade, profession or business, are allowed subject to limitations or ceilings for the itemized deductions in accordance with set criteria like:

(a) Adequacy of the prescribed limit considering actual expenditure requirements of each industry; and

(b) Effects of inflation on expenditure level.

Under Category II, the applicable tax rate schedule was:

Chart 6-5
Tax Rates on Business Income and Income from Profession

Net Taxable Income	Marginal/Statutory
Less than 10,000	5%
10,000 to 30,000	500 + 15% of excess over 10,000
30,000 to 150,000	3,500 + 30% of excess over 30,000
150,000 to 500,000	39,500 + 45% of excess over 150,000
Over 500,000	197,000 + 60% of excess over 500,000

Personal and additional exemptions allowed under Category I are also applicable under Category II. However, for taxpayers with mixed incomes, like for example, those receiving compensation aside from other income, the amount of exemptions is deducted first from the gross compensation and the excess deducted from other income.

(3) **Category III** - *Passive and Other Income*

The third category covers incomes from interest, dividends, royalties, prizes, and other winnings and share of individual partners in the net profits of partnerships taxable as corporations.

Under this category, passive incomes received by citizens and resident aliens are subject to final withholding tax on the gross amount. The rates of tax to be withheld are:

Chart 6-6
Tax Rates on Passive and Other Income

Interest -	15% from savings deposit 20% from time deposits and yield from deposit substitutes, trust fund and similar arrangements.
Dividends -	15%
Royalties -	15%
Prizes and Other Winnings -	15% if exceeding P3,000
Share of individual partners in the net profit of partnerships taxable as corporations -	15%

Batas Pambansa 135, the law embodying gross income taxation was based on an intensive five years of research work by the National Tax Research Center (NTRC). Expectedly, the most vocal proponent of said law was no less than Dr. Angel Yoingco, then director of NTRC. According to Dr. Yoingco, the effects of the tax scheme are the following:[85]

(a) Gross income taxation eliminates discretion between taxpayers and tax officials.

While the old system of net income taxation presented a wide latitude of discretion to both taxpayers and the tax authority, gross income taxation deviates from the old scheme by limiting certain deductions to business income, like expenses incurred in connection with business.

(b) It simplifies the administration of income tax.

The new scheme facilitates collection of taxes as it departs from the more complicated manner of payment simply by placing taxpayers under a final withholding tax system.

(c) It grants the much needed relief in terms of higher exemption allowance.

Gross income taxation provides higher amounts for personal and additional exemption allowances which may be subjected to future adjustments depending on certain economic variables like consumer price indices, minimum wages, and others.

(d) The new tax scheme lessens government revenue from taxation.

Because tax rates for compensation are diminished, and exemption allowances are increased under B.P. 135, the government, consequently will lose some of its revenue from taxation.

B. *Post EDSA Revolution Developments*

For every change in the administration, among the first to be reorganized are the revenue agencies with the purpose of purging them from corrupt officials supposedly belonging of the former administration. This is because these offices, being involved in the collection of public funds, easily attracts employees who want to get rich quick the irregular way. It may be said, therefore, that most "reforms" involve personnel changes.

Along with changes in the persons of the employees were the personnel-oriented enhancements. In Martial Law Philippines, this included increase in the salaries of revenue personnel faster than those of other bureaus, yearly increase in appropriations for the maintenance and operations of the BIR, and, in general, provision of facilities for wholesome environment for efficient revenue administration.[86] Among the early assessment of the personnel oriented reform strategies in that era stated that:

> The response of the BIR personnel to the concern of the Administration has been rewarding: the gross revenue collections of the BIR of P2.501 billion in 1971 is 20% over its 1970 collections of P2.084 billion, and the cost (tax effort) to collect every peso of revenue went down by 18% from P0.022 in 1970 to P0.018 in 1971.[87]

When the Aquino government took over in 1986, personnel reforms along the same lines were also implemented. Comparatively speaking, the

and winnings on the other hand, are uniformly subjected to a final tax of 20%. The 15% final tax on dividends was eliminated in 1989.

(2) Personal exemptions were raised supposedly to avoid taxing income below the poverty line. The figures, however, are practically unrealistic.

The increases in basic personal exemptions to give tax relief to taxpayers, were as follows:

TABLE 6-7
Increases in Basic Personal Exemptions Under EO 37 (1986) and RA 7167 (1991)

	PD 1773	EO 37	RA 7167
For single or married but judicially decreed as legally separated, with no qualified dependent	P4,000	P6,000	P9,000
For head of family	5,500	7,500	12,000
For married individuals	8,500	12,000	18,000

The additional exemption for each of the taxpayer's qualified dependent children, not exceeding four, is P5,000.

(3) Separate computation of income of married couples was also introduced beginning with income earned in 1986. However, they are still required to file a joint return because they remain one taxable unit. Consequently, if they opt for separate computation then each spouse is entitled to a P6,000 basic personal exemption and the additional exemption for dependent children can be claimed by only one spouse. For legally separated couples, the additional exemption for dependent children can be claimed only by the spouse to whom the custody of the children was awarded.

b. *For Corporations*[92]

(1) A uniform rate of 35% substituted for the dual rate of 25% on the first P100,000 of net income and 35% on the excess thereof.

(2) Dividends of domestic corporations issued to domestic or resident foreign corporations are tax exempt.

2. Travel Tax[93]

Executive Order No. 25 exempts qualified Filipino overseas workers from the payment of travel tax. This is in recognition of their dollar earning contribution.

3. Export Duties[94]

Export duties imposed on all export products under Section 514 of the Tariff and Customs Code were abolished pursuant to Executive Order No. 26 as a step towards trade liberalization. However, the 20% export duty on logs is retained in consonance with ecological policy of the government.

4. The Value Added Tax System (Executive Order No. 273)[95]

The Value-Added Tax system is considered as one major component of the 1986 tax reform program. According to the administration "it is the most aggressive step ever taken to effectively source revenues for the government, by completely overhauling the old sales tax system."

The adoption of VAT was met with varied reactions. Critics point to certain weaknesses such as: (a) regressivity; (b) bias against labor and employment; (c) inflationary at turnover; (d) costly to comply and administer; and (e) requirement for massive information. It is admitted, though, that constraints in manpower and equipment resources limited the scope of coverage of the VAT system.

Proponents, including the leaders of the business sector, on the other hand, argue that the advantages outweigh the disadvantages. For one, VAT has a self-checking feature. This insures collection of taxes. The issuance of sales invoices is required since the invoice is made as the only document that can prove that one is entitled to a tax credit (input taxes). All purchases made from VAT registered person entitles the buyer to claim input taxes even if no separate billing of the tax is made on the invoice. The simple application of the factor of 1/11 determines available input tax to the buyer. It, therefore, removes discretion. Further, there is visibility and neutrality of

the tax. It is hoped to increase tax consciousness, compliance and greater fiscal flexibility.

VAT as a system is not new to Filipinos. It restructured and replaced certain taxes already existing in the Tax Code. It also removed the payment of privilege, fixed or graduated taxes, benefiting even those not covered by VAT. The varying rates imposed on importation of articles or locally sales of goods and services were replaced with a single rate of 10%.

There are many other economic activities subject to percentage taxes which are not covered by VAT, such as: caterers, common carriers, hotels on their room rates, franchise grantees, banks, insurance companies and several others. VAT does not cover seller of goods and services with gross sales of not more than P200,000 in a twelve-month period.

The focal point of VAT is on the tax credit system, a system have been used since 1978 on the manufacturer's or producer's level and in 1986 on the importer's level. VAT allows tax credit in all levels of distribution from manufacturer to the retailer.

VAT favors export of goods and services. Exporters who buy capital equipment can apply for cash refunds on taxes passed on to them.

Under the old system, each branch pay their percentage taxes and file their returns in their respective Revenue District Offices. Under VAT it is only the principal place of business or head office that files the consolidated return and pays the tax still due.

However, the recording of transactions under the new system is more comprehensive as it requires mandatory registration of subsidiary books in addition to the general journal and ledger. So, if a company has several branches each branch must have its own subsidiary sales journal and a subsidiary purchase journal, if also engaged in buying operations.

The success of VAT depends on effective registration process. Those whose sales exceeded P200,000 must be registered while others may do so on a voluntary basis. In the optional or voluntary registration, the registrant will stay in the system for a minimum of two years and all sales are subject to 10% and not the lower rate of 2%. What drives voluntary registration is the benefit of the tax credit system.

The new system also introduced a staggered schedule in the filing of returns and payment of taxes due by assigning the entire VAT taxpayers into three groups with periods that may be entirely different from their calendar quarters for income tax purposes. This was designed to decongest filing

centers and allow the government more liquidity as a result of an alternating monthly remittance.

The Commissioner of Internal Revenue, under the VAT law, is authorized to impose penalties like suspension of business operations and temporary closure of business establishments for failure to issue receipts or invoices, failure to file VAT return, understatement of sales or receipts by 30% or more of the correct taxable sales or receipts, and, failure of a person to register as VAT taxpayer as required.

5. **Reclassification of Excisable Articles (Executive Order No. 273)**[96]

Many articles were declassified as excisable and were only subjected to VAT, such as watches, video tapes, solvents and compounded liquor. However, other articles were transferred to the excise tax system such as non- essential goods, mineral products and automobiles.

In addition to the excise tax imposed on the articles, the VAT rate of 10% is also imposed.

6. **Transfer of Collection (Executive Order No. 273)**[97]

EO 273 transferred the collection of fees and charges to other government agencies and instrumentalities, as in the imposition of occupation fees and rentals on mining claims by the municipality or city where the claim is situated and charges on forest products by the Forest Management Bureau of the Department of Environment and Natural Resources.

C. *Increase in Revenue Collections*

In view of the reforms introduced in the BIR and in the BOC, it can be noted that revenue collections have been increasing. It was observed that in the BIR, a substantial portion of the additional tax revenue was due to stricter administration of existing taxes and duties.[98] Table I shows that there is an average annual growth of 20.17% in the collection of taxes from 1961 to 1990. In the pre-Marcos years (1961 to 1965) the annual growth rate was 14.59%, while during the first term of Marcos (1967 to 1971) it was 13.46%. Growth rate was highest during the New Society era (1972 to 1985) at 28.53% and declined to 20.35% in the post-Marcos years (1986 to 1990). It is significant to note that the first two years of Martial Law posted the highest growth rate of an average of 82.62% reflective of serious efforts of government collection effort coupled with taxpayers' positive response.

Meanwhile, from 1981 to 1983, performance was very low at an average of 5.74%. This reflects the apparent neglect in the mobilization of domestic

resources which resulted in the deterioration of tax revenues to its lowest, at 9.9% of gross domestic product. This was partly offset by the easy access to external sources of financing at that time. Nevertheless, fiscal deficit soared to 4.2% of GDP in 1982.[99]

Table I

BIR TAX COLLECTION FROM 1961 - 1990

Calendar Year	Collection (P Billion)	Percentage Increase Over Preceding Year
1961	0.7	-
1962	0.8	14.29
1963	1.0	25.00
1964	1.1	10.00
1965	1.2	9.09
1966	0.8	-33.33*
1967	0.9	12.50
1968	1.0	11.11
1969	1.2	20.00
1970	1.3	8.33
1971	1.5	15.38
1972	2.8	86.67
1973	5.0	78.57
1974	6.5	30.00
1975	6.8	4.62
1976	8.7	27.94
1977	10.5	20.69
1978	11.9	13.33
1979	14.5	21.85
1980	17.3	19.31
1981	18.8	8.67
1982	20.0	1.06
1983	21.5	7.50
1984	32.1	49.30
1985	41.7	29.91
1986	47.0	12.71
1987	58.6	24.68
1988	63.4	8.19
1989	82.2	29.65
1990	104.0	26.52
	Average Annual Growth	20.47 percent

Note: * Percent growth rate in 1966 over 1965 may be incorrect due to different data sources between the two periods.

Sources:
For 1972-1989: BIR Annual Report, various issues.
For 1990: Department of Budget & Management.
For 1961-1965: PIDS Working Paper No. 81-08.
For 1966-71: COA, Report of the Auditor General to the President.

Compared to its goal, it was only from 1972 to 1976 that actual collections steadily surpassed the goals. Starting 1977 to 1983, collection performance was below the targets. It was only in 1984, 1987 and 1989 that collections exceeded the targets. Table II compares the actual collection with the goal.

Table II

COLLECTION COMPARED TO GOAL

Calendar Year	Goal (PBillion)	Collection (PBillion)	% Increase (Decrease Over Goal)
1972	1.7	2.8	64.71
1973	2.9	5.0	72.41
1974	5.0	6.5	30.00
1975	4.7	6.8	44.68
1976	7.8	8.7	11.54
1977	10.6	10.5	(0.94)
1978	12.7	11.9	(6.30)
1979	15.3	14.5	(5.23)
1980	20.3	17.3	(14.78)
1981	22.8	18.8	17.54)
1982	21.1	20.0	(5.21)
1983	22.3	21.5	(3.59)
1984	31.6	32.1	1.58
1985	42.4	41.7	(1.65)
1986	47.3	47.0	(0. 63)
1987	57.3	58.6	2.27
1988	69.9	63.4	(9.30)
1989	79.7	82.2	3.14
1990	-	104.0	-

Source: BIR Annual Report, various issues.

On the other hand, the Bureau of Customs' collection effort for 1984 have shown remarkable increase. On its revenue collection for that year, the Bureau chalked up a total of P19,068,000,000.00 representing an increase of 17.53% over the 1983 actual collection of P16,223,000,000.00. It also exceeded the 1984 budgetary target of P19.028 billion by 0.21%.[100]

There is an increase of 9.47% for imports over the 1983 collection. Compared with its budgetary target, the 1984 collection fell short by 3.55%. As to exports, the 1984 collection indicated an impressive increase of 498.03% over 1983 collection and was above 60% from its target.[101] (See Tables III and IV).

Table III

COMPARATIVE CUSTOMS COLLECTION

SOURCE	BUDGET ESTIMATE (million pesos)	ACTUAL 1984 (million pesos)	INCREASE (DECREASE)	PERCENT
Import Duty and Tax	17943	17328	(615)	(3.43)
Export Premium Duty	1000	1519	519	51.87
Other Income	85	136	136	160.35
TOTAL	19028	19068	40	0.21

	ACTUAL 1984 (million pesos)	ACTUAL 1983 (million pesos)	INCREASE (DECREASE)	PERCENT
Import Duty and Tax	17328	15829	1499	9.47
Export Premium Duty	1519	254	1265	498.26
Other Income	221	140	81	57.58
TOTAL	19068	16223	2844	17.53

SOURCE: Aduana, 1984 Annual Report, Bureau of Customs.

TABLE IV

DETAILED STATEMENT OF INCOME SOURCE

TYPE OF INCOME	ACTUAL 1984 (million pesos)	ACTUAL 1983 (million pesos)	INCREASE (DECREASE)	PERCENT
CUSTOMS RECEIPTS	15937	12472	3465	27.78
Import Duties	14199	12088	2111	17.46
Export Duties	1519	384	1265	498.26
Customs Doc. Stamps	20	12	8	66.46
Other Income Including Sales of confiscated goods, operating service income and income and other credits	201	119	82	68.65
INTERNAL REVENUE RECEIPTS	3130	3750	-621	-16.55
Specific Tax on Imports	58	41	16	38.84
Advance Sales Tax	2670	3301	631	-19.13
Compensating Tax	402	399	3	0.76
Internal Rev. Stamps	1	10	-9	-86.48
TOTAL INCOME	19068	16223	2844	17.53

SOURCE: Aduana, 1984 Annual Report, Bureau of Customs.

IV. ISSUES AND PROBLEMS

A. *Revenue Administration*

Revenue administration complements the tax policy and structure. Where it is ineffective, it weakens the entire tax system. It renders tax reforms impractical. Thus, strengthening tax administration is imperative.

Among the numerous problems of revenue administration, the more urgent are: (1) the lack of tax "handles" and (2) the assessment of revenue administration.

1. Lack of tax "handles"

Tax handles refer to the sets of information on the tax subject which are used as bases for tax assessment and collection. The lack of such information can be attributed to the high costs of data collection and analysis, the lack of records pertaining to the object or person's socioeconomic profile, negative public attitude and low compliance on certain taxes, and the nature and business structures of the economy.[103]

The administration of business taxes, for instance, is severely hampered by the inability of the tax administrator to assess reliably and validly the volume of sales that the business establishment has. This is because, the businessman may not divulge all information relevant for tax assessment and collection. In other businesses like small-scale and retail trade, no accounting records are kept. Taxing the multinational corporations (MNCs) is even more difficult, because of manipulation of accounting and other information and other evasive tactics like "transfer pricing". As pointed out in Chapter 15 (Government Accounting System, see: Issues and Problems), inadequacies in the accounting systems and procedures prevent the generation of data that can provide a valid and reliable basis for effectively taxing the business activities of foreign corporations.

The problem of tax handles is partly due to the inability of the accounting field of study and practice to meet the needs of tax administration. Either there is a lack of accounting information or where there is, it is inadequate to supply the information actually needed by tax assessment and collection. In addition, willful neglect or evasion on the part of the business in question, sometimes in collusion with members of the accounting profession, makes the job of tax assessment more problematic.

Another problem as regards tax handles is the lack of socioeconomic data which can provide a valuable basis for the design of tax systems and schemes. Among the information desired but inadequately gathered are: the assets and liabilities, per capita income, expenses and disabilities, and others. These statistics are particularly important for direct taxation such that the ability to pay, uniformity, and equitability principles of direct taxation are achieved. A case in point is the perceived flaw in the gross income taxation scheme where it is believed that the scheme is too stiff for the middle income class. The elimination of the deductions previously allowed under the old scheme and the new applicable rates obviously did not take into account "the way of life of the people who are deemed to fall under the middle-income category."[104] For example, school expenses (a great majority of middle class families send their children to colleges), house rents and amortizations, the average number of earning members of a typical middle class family factors, may not have been accounted for in formulating the scheme.[105]

2. **Assessment of Revenue Administration**

An important part of revenue administration which remains inadequately performed is the conduct of fiscal and performance audits to assess revenue administration. Audit of agency operations, if done objectively and oriented towards problem- solving, can provide useful information as a basis for the improvement of revenue administration. A special type of external audit, the revenue audit, can assist the tax administrator in the identification, analysis and solution of the problems behind the administration of tax policies and systems.

Revenue audit examines all income derived from the regular system of taxation (revenue) including the cash inflows realized from the operations and activities of the government or received by it in the exercise of its corporate functions (receipts). Approached on a post-audit basis, revenue audit will look at the regularity and completeness of collection, the accuracy of recorded and reported amounts, the deposit of collections, their proper classification, and the adequacy of controls over revenue accounts.[106]

The function of conducting this type of audit rests in the Commission of Audit (COA). Thus far, revenue audit has not been substantially performed to the extent that it has maximally benefited our tax system.

Partly due to overemphasis on audit of disbursement and pre-audit, revenue audit was not given enough attention by COA.[107] Hopefully, with the latter's efforts in redirecting audit activities to post-audit and instituting comprehensive auditing, revenue audit will be expanded to include the evaluation of the revenue agencies' performance by assessing their programs, strategies, and objectives in terms of their effectiveness, economy and efficiency aspects. The performance of revenue audit necessitates however, the cooperation and support of the agencies concerned, if to render an objective appraisal useful for the improvement of revenue administration and the entire taxation system.

B. *Tax Structure*

1. Capital Formation and Allocation of Resources

A tax structure for generation of resources encounters the problem of reconciling tax efforts and performance with the capacity of the taxpaying public.

The ideal rate of capital formation is 12 per cent of the Gross National Product (GNP), according to experts. This is usually a tall order for societies where the usual rate of savings generation is around 5 to 6 percent.[108] Assuming that the prescribed rate is the goal for economic growth, how the

government can accomplish such goal is a major problem. In the Philippines, this is a persistent problem. Like all other developing countries the government has to compensate for the low level of capital formation in the private sector by utilizing tax revenue to capitalize major projects. Either due to the problems attendant to tax administration or to more important considerations like the perceived urgency of development spending, the government has difficulties in generating resources from within. It therefore increasingly resorted to huge foreign borrowings in the hope of augmenting the low tax-GNP ratio of capital formation. In addition, it has attracted foreign capital at a pace which alarms some sectors of the society. There are possibilities still open. It is claimed that the Philippines is still undertaxed. It is even officially conceded that we are one of those countries with lowest rate of taxes, particularly with income taxation.[109] Furthermore, it is believed that some taxable sectors have not been contributing what is due from them. An example of such sectors is the higher income class which consume highly-taxable luxury and other imported items. Continuous efforts should therefore be exerted to maximize the generation of capital investment from domestic sources (local and foreign).

Tax efforts have had some success as evidenced by the expansion of the tax base and the resulting dramatic increase in revenue collections since 1972. As pointed out in Chapter 7, however, the revenues generated when compared to actual public expenditures remain inadequate. The gap between revenues and expenditures is a perennial problem. To increase tax revenues, however, the usual tax strategy has been to raise the indirect taxes. As noted previously, the indirect taxes are more conveniently collected. The composition of the total national revenues since 1972 is characterized by an increasing proportion of indirect taxes. The dominance of indirect taxes over the direct ones has even increased. (See Chapter 7, Patterns of Philippine Revenue). These developments have already had serious implications on the simultaneous efforts to achieve equity in taxation. It is worth reiterating that indirect taxes like sales and excise taxes have indiscriminate effects on the population, hence, even the poor segments of the tax population have to pay the same amount as the rich.

Problems of efficient allocation of resources for maximum utilization and balanced socioeconomic development lie in the present structure of tax incentives and disincentives.

A most urgent issue is the granting of tax incentives to foreign investments. While the strategy to attract foreign investments for capital investment is necessary and beneficial to some extent, the design of a tax structure for foreign capital is beset by many difficulties and painful tradeoffs.

The structure of tax incentives is always confronted by the problem of striking a proper balance between the over-all benefits of capital formation

and the attendant disadvantages from the effects of economic growth and stability. The ideal situation is complicated by several problems. First, there is always the fact that the tax incentives granted to foreign investors reduce the country's share in the profits generated by foreign capital. Thus, the loss must be compensated for by gains from additional capital infusion.[110] Second, the design of tax incentives must prevent the foreign capital from exploiting local domestic savings. There is little gain to the host country if foreign investors partake of the already scarce capital. Since 1950's some significant part of locally generated savings has been used by foreign investors either directly or through local institutions controlled by them, to further expand their operations.[111]

Third, the tax structure should encourage reinvestment and permanent operation. Our tax performance has had limited success because of the MNC's repatriation of profits to their countries of ownership.[112]

A final problem arises in connection with the competition among less developed countries for foreign capital participation. To the extent that developing countries try to outbid among each other by offering greater tax incentives, some degree of cooperation among developing countries especially in regional associations is needed in order to avoid cut-throat competition.[113]

In addition, a greater degree of fiscal control and assessment for tax purposes can be achieved particularly for MNCs which operate in a particular region.

2. Redistribution of Income and Wealth

The problem of redistributing income and wealth through the various measures like the gross income taxation scheme or tax incentives for investments in lagging areas and sectors, poses the question of how and to what extent is the present tax structure equitable and progressive.

In Philippine experience, the evolution of the tax structure towards the redistribution of income and wealth is characterized by efforts to institute progressivity by strengthening the direct system of taxation. The introduction of the Gross Income Taxation scheme is one of such efforts.

But even the scheme suffers from deficiencies as to redistributing the tax burden on equitable basis. A relevant point is its perceived negative impact on the middle-income class. Among the income groups, the middle income bracket is considered to be the most burdened by the withholding tax system and the limited personal exemptions and deductions because majority of those in this class are fixed-income earners.

It is believed further that the past are still inadequate considering the increasing reliance on indirect taxation. Many feel that the redistributive effects of taxation should be directed more towards checking the alarming growth of indirect taxation. The prospects of implementing such efforts however are not exactly feasible. First, there is the consideration of priorities. At present, our priority seems to be the generation of more revenues in the face of our annual budget deficits. Secondly, there is the urgency of development spending fueled by anxiousness over the uncertainties of future global economic conditions. The revenue generation thrust of the government through indirect taxes can not be second to considerations of redistribution of wealth and income. It is an issue which should be solved first. The experience shows that the adequacy and certainty of revenues are given more importance.

Another problem concerns the indirect strategy and redistribution, through tax privileges like incentives, tax subsidies, exemptions, and the like. The long-run effects of the program's tax concessions on the improvement of the income of beneficiaries remain to be seen. What deserves greater concern is who the real beneficiaries of the program are and who enjoy the tax benefits. Obviously the structure of such tax incentives prioritizes employment-generation over the impact on the redistribution of capital resources.

3. Economic Stability

A tax structure that can promote economic stability is ideally that which can respond swiftly to the impact of world market forces in the short-run, and enhance the long-run efforts to diversify the economy, and realize the maximum socioeconomic benefits from the participation of foreign investment.

A major problem concerns the need for revenues from trade activities. The government imposes import and export taxes in order to generate revenues. At the same time, it has to set the rates at a level which is consistent with other economic objectives. Thus, it has to protect the home industries by imposing high import tariffs. It may also have to restrict imports in order to save foreign exchange. The government may also impose high export taxes in order to discourage underutilization of inefficiency in the export industries or build up its foreign exchange resources. It may likewise decide to lower export taxes in order to make its exports more competitive in the world market. The occasion for the lowering and increasing of tariffs and duties depend upon external forces. Thus, an important feature of a tax structure should be its ability to take advantage of opportunities and to protect the economy during instabilities.

In essence, the tariff structure must be flexible enough to permit skillful manipulation of import and export taxes. In the Philippines, and despite opposition from foreign interests like the World Bank, we had demonstrated our modest success during the oil crisis.

Increasingly however, the government has to face the realities of its relationship with foreign interests. The World Bank-IMF, for instance has been pressuring the Philippine government, through "agreements" built into loans granted to the country, into adopting "free trade" measures, one of which is the reduction of tariffs on imports.[114] Such tax measure has direct benefits for the products of Western countries which actually control the WB-IMF. It makes their finished goods more competitive in our local markets. On the other hand, the Philippines loses revenues to a disadvantage. Unfortunately as is becoming apparent by now, the WB-IMF have had some degree of success in influencing the fiscal policies of the country particularly the latter's tariff structure.[115]

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CHAPTER 7

PATTERNS OF PHILIPPINE REVENUE 1960-1990

I. INTRODUCTION
Objectives of Government Finance and The Revenue System

II. INCOME SOURCES OF THE PHILIPPINES

A. Tax Revenues
B. Capital Revenues
C. Grants
D. Extra-Ordinary Income
E. Public Borrowings

III. TRENDS IN THE GENERAL GOVERNMENT REVENUE SYSTEM

IV. REVENUE PERFORMANCE BY LEVEL OF GOVERNMENT

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PATTERNS OF PHILIPPINE REVENUE 1960 - 1990

I. INTRODUCTION

The government revenue system, including the agencies involved in taxation and borrowing, has always been the focus in the study of public finance.

Public revenues are funds used not only to keep the government machinery going but also to enable the government to carry out its various fiscal functions of allocation, distribution, and stabilization.

The Philippine revenue system has assumed more importance since the government has steadily increased its role in the provision of social goods (goods of public nature) which the private sector could not (or does not want to) produce for reasons of unprofitability.

Since the government's development role is pervasive and massive, the strength of its financial capability can spell success or failure of its development plans and strategies. A look at the patterns of Philippine revenue in the past may reveal some insights into how and to what extent the Philippine government has financed its development programs.

Objectives of Government Finance and The Revenue System

> *"A stable macroeconomic foundation is one of the most important public goods that governments can provide. Experience shows that when government spending has expanded too far, excessive borrowing or monetary expansion, and problems in the financial sector, which have been quickly followed by inflation, chronic overvaluation of the currency and lose of export competitiveness. Excessive borrowing led to domestic and external debt problems and to domestic and external debt problems and to the crowding out of private investment".* [1]

> *"Fiscal and financial instability have sometimes been partly inflicted on governments by external events - or by internal shocks such as civil wars or national disasters.* [2]

The traditional objective of government finance is the maintenance of the state that protects the territory and its inhabitants. Carrying out these objectives necessitates the establishment of a revenue system, the principal device for the mobilization of financial resources.

Of prime importance is the promotion of economic development by the ernment through direct financing, like the construction of infrastructures l direct involvement in certain productive activities to fill the gap the private tor has left, and through public entrepreneurship by the use of govern- nt corporations or public enterprises.

Economic development is pursued directly, maintaining economic sta- y, through compensating actions for fluctuations in business activities by use of taxes that can adapt to the changing conditions and needs of the nomy. Thus, some forms of taxation help stimulate investment.

In combination with such other devices as socialized pricing, and credit l exchange controls, the revenue system is a major device against ation and an effective tool in achieving economic stability, employment l income redistribution.

In the area of social development, improvement through the provision education and health services and income redistribution for a more anced economic growth can be achieved through taxation and expendi- e policies.

In sum, government finance is geared towards the attainment of devel- ment objectives, e.g., the improvement of the quality of life of the people.

INCOME SOURCES OF THE PHILIPPINES

The term "public revenues" as used here pertains to "all incomes or eipts of the government treasury used to support government expendi- es."[3]

It has been noted that there are differences in the classification of counts among the government agencies involved in the collection, fiscal licy, resource generation, budgeting and fiscal control and management. 1977, the Commission on Audit and the Ministry of the Budget (now the partment of Budget and Management) revised the classification of ac- unts. The division of accounts into sections was initiated for the purpose detailed recording and reporting in accordance with the existing practices, es and regulations and for the International Monetary Fund's (IMF) Gov- nment Finance Statistics, which makes possible international comparison ong the IMF's member countries.

The Philippine revenues are derived from five main sources:[4]

1. Tax Revenues
2. Capital Revenues

3. Extra-Ordinary Income
4. Public Borrowings
5. Grants

1. *Tax Revenues* - cover compulsory contributions to finance government activities. Taxes are computed at the rate established by law to a defined base such as income, estate, imports, etc., without any direct relation to the benefits enjoyed by the individual assessed. It is the primary and traditional source of income.

Tax revenues fall into two categories: direct and indirect. Direct taxes are those whose payment is absorbed by the person on whom the taxes are imposed. Examples are income, transfer, real property and community taxes. Indirect taxes, on the other hand, are those charges paid by a person other than one on whom they are legally imposed. These include license, business and occupation taxes, import and export duties, sales, energy, and stamp taxes, and others. Direct taxes, unlike the indirect, cannot be shifted to other tax subjects. Thus, direct taxation is more effective in achieving equity in distribution of income.

The major tax revenues of the Philippines are classified as follows:

a. *Property taxes* - levied on the use or ownership of wealth or immovable property. This category also includes all those taxes on changes in ownership of property either through sale, inheritance or gift-giving.

b. *Income taxes* - imposed on incomes of individuals, corporations and partnerships; and all fines and penalties charged in relation to their collection.

c. *Amnesty taxes* - imposed by special laws as in the series of Presidential Decrees on delinquent taxpayers who were granted: (i) amnesty for their declaration of previously undeclared income without fear of prosecution; and (ii) immunity from charges of previous non-declaration of actual income, provided that such are availed of within a prescribed period of time.

d. *Estate and gift taxes* - "an estate tax is a tax on the privilege of the decedent to transmit property at death, and is based on the entire net estate regardless of the number of heirs and relation to the descendant."[5] This is in contrast to the former inheritance tax, which was "imposed on the privilege of the heirs to receive property from the decedent upon the latter's death and is based on the share of each heir."[6] Gift taxes may be in the form of donor's or donee's taxes; the former, being a tax on the privilege to give and the latter,

a tax on the privilege to receive. The Philippine jurisdiction impose only the donor's tax. "These are enacted by law to prevent undue concentration of wealth or to limit fortunes by taxation."[7]

e. *Community tax* - a poll tax charged from individuals, partnerships and corporations residing in the Philippines.

f. *Immigration tax* - includes all taxes and charges imposed upon immigrants under the immigration laws.

g. *Excise* (specific) *taxes* - those covering imports and exports such as specific trade and compensating taxes on alcohol, sugar, playing cards, etc.; license fees on exported goods except wharfage taxes and taxes on goods manufactured, produced or assembled in the Philippines; taxes on the sale of foreign exchange; mining taxes; and taxes on agricultural products except charges on forest products.

h. *License and business taxes* - include privilege taxes, fixed percentage and similar taxes on brewers, or on occupation, practice of profession, etc. A license is basically a regulatory measure.

i. *Import duties* - cover all taxes on foreign goods levied in accordance with the tariff laws and regulations except wharfage fees.

j. *Documentary stamps taxes* - levied upon documents, instruments, papers, acceptance, assignments, sales and transfer of obligation, right or property incident thereto; debentures, certificate of indebtedness, original issues or certificates of stocks, etc.

k. *Charges on forest products* - include all taxes charged on timber and firewood cut in public forest, wood cut from unregistered private lands, and on other forest products.

l. *Wharfage fees* - charges for wharfage relative to imports and exports.

m. *Franchise taxes* - imposed for any special right or privilege granted by a government, e.g., the right to sell a product.

n. *Import tax* - levied on imported materials to control their entry into the local market.

o. *Miscellaneous taxes* - cover all other taxes not covered by the above-listed categories.

2. *Capital revenues* - cover proceeds from sales of fixed capital assets or scrap thereof and public domain and gains on such sales like sale of public lands, buildings and other structures, equipment, and other properties recorded as fixed assets.

3. *Extra-Ordinary Incomes* - include repayments of loans and advances made by government corporations and local governments and the receipts and shares in income of the Central Bank of the Philippines, and other receipts.

4. *Public Borrowings* - cover the proceeds of repayable obligations generally with interest from domestic and foreign creditors of the government in general including the national government and its political subdivisions. The national debts refer to those debts accruing to the central government. The role of public borrowings is gaining emphasis in the Philippine fiscal system. It is resorted to for financing deficits to balance the budget and for compensating for fluctuations in the economy. This is due to the deficiencies of expenditure performance and/or rate of revenue collections. The Philippine government borrows primarily to finance infrastructure and capital improvements. However, since the global debt crisis of the eighties and the Philippine balance of payment crisis in 1983, government has been borrowing primarily to service the debt and cover balance of payment deficits.

5. *Grants - cover voluntary* contributions and aids given to the government for its operation on specific purposes. It does not require any monetary commitment on the part of the recipient. It can be in the form of money and/or materials.

III. TRENDS IN THE GENERAL GOVERNMENT REVENUE SYSTEM

This section attempts to describe and analyze the trends of the government's revenue operations for the last three decades. For our purposes, the period shall cover the years from 1960 to 1990. It is important to note that in 1976 there was a change in the financial reporting periods, i.e., from fiscal (June-May) to calendar year (January-December).

A three-period analysis is done, i.e., before (1960 to 1964), during (1965 to 1985) and after (1986 to 1990) the Marcos administration. Revenue trends at current and constant prices (see Figure 1) are described and analyzed in terms of growth and growth composition (as illustrated in Figures 2A, 2B, 4A , 4B and 4C). In addition, the real and per capita values of the aggregate revenue are obtained and analyzed to account for inflation and population growth. Emphasis is, however, made on the Martial Law and the Aquino years.

A. Growth of General Government Revenues

1. *Aggregate Growth and Composition*

a. The Pre-Marcos Era (1960-64)

From 1960 to 1964, the aggregate general government revenue increased from P1.5 billion to P2.4 billion. This reflects an average growth rate of 12.17 percent. Relative to national income, this performance shows a decreasing trend, from 13.8 percent to 13.6 percent. This decrease is accounted for by the decrease in national revenues in contrast to the increasing trend for local revenues. Considering national income as an indicator of economic growth, this only reveals a lag in the revenues of less than one percent which seems not much of a problem yet.

Compared to expenditures, however, an average annual deficit of P10 million is already huge. It is essential to note that peculiar to the Philippine financial system, borrowings are included as part of revenues. So, if revenues net of borrowing is taken into account, the deficit jumps to P175.6 million a year.

Tax revenues constitute over 70 % of total revenues while borrowings only 8.4 %. This shows the heavy reliance of the government on taxation rather than on any non-tax sources including borrowing.

Compared with other Asian countries, the Philippine performance is definitely low. Yoingco and others made a study on the tax performance of seven countries for 1960 to 1962: including India, Indonesia, Japan, Malaysia, Philippines, South Korea and Thailand. On the average, all countries except the Philippines with only 9 percent and India, 6 percent, had more than 13 percent tax to national income ratios. Malaysia had the highest with 18.5 percent, followed by Indonesia, 17 percent and Japan, 14.7 percent.

Even as early as this time, there were already indications that the Philippine tax system and the revenue system in general, need to be upgraded if the government were to cope with the rising needs of its people.

b. Pre-Martial Law Marcos Years (1965-1971)

No relevant increases were observed during this period. In fact, for some of the years, the figures were as high as in the early 60s.

Relatively significant changes were, however, observed in the composition. In Figure 5, it is clear that although, tax revenues remain the number one source of income, it is noticeable that its ratio to total has started to

decline in the late 60's and early 70's. It was during this period that the government granted tax amnesties which partly increased collections.

Another reason was the slight rise in the share of borrowing to total revenues. It may be recalled that during this time obtaining credits from foreign sources was a lot easier since the creditors themselves were also eager to dispose of their excess dollars. The Marcos government then embarked on a massive "development" spending which led to the rise of the country's debt to high level.[8] More detailed discussion on public debt is done in Chapters 13.

Receipts from public debt were mostly spent on servicing debts. The rest went to developmental projects and other budgetary needs.[9] Meanwhile, budgetary expenditures do not result in immediate increases in total output. In addition, debt financed expenditures have usually inflationary effects.

c. The New Society (Martial Law Years: 1972-1985)

The New Society era ushered in record high deficits which were covered up by excessive borrowings. The revenue structure is shifted from one which was made up of more tax revenues to one which has become more borrowing-dependent.

National revenues relative to local contributions rose to an average of over 90 % compared to 1960-1964 and 1965-1971 averages of 79.7 % and 79.8 %, respectively (see Figure 3). This increase is due to the growth in borrowings much more than increases in either tax or other non-tax collections (see Figure 5). In fact, decreases in ratio of tax revenues to total net of borrowing were observed during this period. The decrease is partly due to the government losses brought about by the various exemptions/concessions granted especially to government corporations which were substantial[10] and due to the rapid growth in borrowings relative to tax collections.

Borrowings during this period averaged to 31 % of total revenues as against the 21 % in 1965 to 1971 and 19 % in 1960 to 1964. The ratio of tax revenues to total declined greatly from an average of 73 % in 1960 to 1964 to 55 % of total. The percentage of non-tax sources of revenues recovered a little from 12 % in 1965 to 14 percent in 1971, although it is still below the 1960 to 1964 level.

d. The Aquino Administration

In recent years, no substantial growth in real government revenues is observed if real revenues net of borrowing is looked at. In fact, from P22,599 million it declined to P20,212 million in 1990, at 1972 prices. As a percentage

of national income government revenues went down to 21 percent in 1990 from 27 percent in 1986.

National revenues ratio to total is highest at 93 percent (Figure 3) brought about by the larger borrowing component of the national revenues. In Figure 1, local revenue trends show an almost flat line compared to the distinctly rising national revenues.

Annual rates of growth (Figures 2A and 2B) display an unstable pattern for the both the national and local revenues but distinct peaks were observed during the early seventies and late eighties. This could be explained by massive investment expenditures especially on infrastructures by the government in the seventies which were achieved through excessive foreign borrowings. In the eighties, the Aquino government was faced with a huge debt to service which it inherited from the past administration. The onset of the debt crisis in the 80s made the foreign funds scarce, the government was then forced to go into more domestic borrowings. This increased the revenues for the period.

Meanwhile, the decline in the rate of growth in the late seventies to the early eighties, was brought about by both national and international crises which aggravated the debt problem leading to the declaration of a moratorium in debt payments in 1983.

Looking at the performances of both past and present administrations, no real significant increases in revenues relative to the increasing expenditures were achieved although several structural changes were effected. All these reveal how the revenue system have lagged in terms of coping up with the rapidly increasing needs for government services and pump priming activities. The average consumers might have been heavily burdened by the imposition of more indirect taxes such as excise sales taxes, as it have always been. Direct taxes, on the other hand, such as income and corporate taxes which would then be progressive, could not be easily increased due to strong opposition of influential groups who are usually the ones sitting in Congress or, if ever passed, the high-income groups often have ways of passing the burdens to the poor consumers.

2. *Per Capita Growth*

Per capita revenues is reflective of what each Filipino supposedly contributes to the government coffers. Hence, the increasing per capita revenues over the years only indicate that absolute revenues increased faster than total population. However, as an indicator of the real tax base it may be a bias measure. For one, the tax burden is not evenly distributed, i.e., it is highly skewed. In addition, the higher income groups have various ways of evading taxes through the existing tax exemptions which set no limit

at all. The poor majority are often more burdened by the indirect taxes which are very dominant in the Philippine tax system.

Per capita general government revenues was registered at P57 in 1960. This gradually increased to almost double in 1968, a span of eight years. During the Martial Law period, revenues increased in absolute terms by over five times in current prices, against an increase of only one-half in current prices of the sixties. In real terms, however, the seventies' rate of growth was largely illusory because of the considerable gap between absolute and real values.

Absolute growths during the seventies was partly due to the increased revenue efforts. More significantly, the 70s saw an acceleration of foreign borrowings, the latter being part of aggregate revenues. Foreign borrowings in the 60s were not as significant as in the 70s.

What factors account for the lower actual growth of the 70s relative to the 60s? One reason was the moderate increases in the wholesale price index in the 60s, while the 70s had a high rate of inflation (see Figure 7 for the trend of consumer price index). Another explanation was the increase in the peso's purchasing power in the 60s (as evidenced by the decrease in the consumer price index) and its tremendous depreciation in the 70s.

The first half of the eighties show relatively modest increases. It may be noted that these were the crisis years. A marked difference is seen when in the late eighties per capita revenues is examined. Considering a constant population growth rate, the increase in the second half of the eighties could only be attributed to the increase in revenues from P2,388 per capita in 1986 to P3290 in 1990.

B. Revenue Structure

Governmental revenues are divided into three broad categories: tax revenue, non-tax revenue and public borrowings.

Figures 4A, 4B and 4C show revenue trends for general, national and local governments by the three categories.

From 1960 to 1964, general revenues were composed of 73 percent tax, 19 percent non-tax and 8 percent borrowings. This was largely changed in 1965 to 1971, when tax revenues was reduced to 67 percent, non-tax to 12 percent and borrowing, 21 percent, almost three times as much as the 1960 to 1964 level (see Figure 5).

This pattern continued except that non-tax went up to 14 percent while borrowing increased by 10 percent and tax declined by 12 percent.

Revenue structure of the period consisted in the following order of share: tax revenue, public borrowings, earnings and other credits (or non-tax revenues), extraordinary income, and capital revenue.

Significantly, public borrowings constituted a more important source of revenue than non-tax receipts. Among the three major sources, borrowings exhibited the fastest rate of growth. During the Martial Law period, as noted above, approximately one-third of total revenues consisted of public borrowings. The pattern of revenue during the 70s and the 80s, clearly reflect increasing reliance on borrowing as a major revenue source. In the seventies, borrowing was resorted to purportedly to finance development projects; during the 80s, it was resorted to service the debt.

Borrowing continued to increase until 1985 while tax remained in the level of over 50 percent but less than 60 percent. In 1986 to 1990, a slight change occurred when borrowing declined to 29 percent from 32 percent in 1981 to 1985 while the non-tax rose to 15 percent from 10 percent. This may be explained by the efforts of the Aquino government to reduce the debt burden, or at least to keep it at its present level.

C. 1960, 1980 and 1988 - Performances

In 1956, Alison and Lewis proposed a revenue model for less-developed countries. It was based on the assumption that government revenues should come in almost equal amounts from both direct and indirect taxes, and on the assumption that grants and receipts from public borrowings of developing countries are insignificant. The Philippine revenue system's performance for 1960 was compared by Abello to the model.[11] The 1980 and 1988 revenue collections were also compared to see how far the revenue system has improved.

Several observations hold: First, although there has been a significant improvement in the revenue efforts in 1980 at 12.30% of GNP compared to the 1960 level of only 11.04%, the overall performance is still not comparable to that of industrialized countries which is close to what the model is representing. The fact is, the model was the ideal in the 60s yet. Twenty years after, one would expect the figures to be higher for a country to cope with the rising needs of increased population and inflation.

Second, income tax revenues were way below what the model projected. In 1980, it posted a growth of 47.25% which is far below that of the model. On the other hand, commercial and administrative revenues registered a substantial increase of 46% exceeding the model by 0.92 percentage

points. The other items which posted increases were the export duties which generated a tax effort of 0.18% and the various miscellaneous taxes which gained a 63.77% increase, i.e., from 0.69% of GNP in 1960 to 1.76% in 1980.

Third, real property, transfer, excise, and sales taxes decreased. The real property tax collection decreased by 8.16% from a tax effort of 0.49% of GNP in 1960 to 0.45% in 1980. However, there are findings showing that the poor performance of the real property tax is due to non-payment of taxes at the rate of over 60%.

The rest of the items exhibited decreases in collection, the most significant of which was the decrease in transfer taxes from 0.40% to 0.05% of GNP or a decline of 87.5%. Import duties, excise and sales taxes showed a substantial decrease of 29.34%.

Fourth, there was a lopsided distribution of direct and indirect taxes in total revenue collection. In 1960, the total direct tax effort was equivalent to 3.1% of GNP and contributed 95.48% of tax revenues while indirect tax effort, 9.17%, with 74.5% share of the tax revenues. In 1980, the tax collection efforts generated 3.13% and 9.17% respectively for the direct tax and indirect tax. As illustrated, the share of direct taxes increased by 4.19% while the share of indirect taxes decreased by 4.19%.

The Alison and Lewis model may not be useful in analyzing revenue patterns during the decade of the 70s and 80s. This is due to the ascendancy of borrowing as a major source of revenue. As noted earlier, the orgy of borrowing which developing countries engaged in on a global scale weakened the use of revenues to finance development. The decade of the 80s saw the Philippines' inability to get out of the borrowing syndrome. Thus, the two decades were dominated by the debt crisis and the addiction to borrowing.

IV. REVENUE PERFORMANCE BY LEVEL OF GOVERNMENT

A. Share of Collected Revenue

Of the average revenues collected in 1960 to 1964, 79 percent came from the national government. Local governments on the other hand, accounted for about one-fifth (1/5). In 1965 to 1985, this became 91 percent against 9 percent for local and 93 percent against 7 percent in 1986 to 1990.

B. Growth

The collections from 1960 to 1990 increased at both levels. National government collections increased from P1,241 million in 1960 to P180,644

million in 1990. The local government collection, on the other hand, likewise increased from P306 million in 1960 to P19,062 million in 1990.

In terms of percentage growth, the annual average of both levels was 24.9%, with the national government registering a faster growth rate at 25.8% compared to the local level's 18.8%.

There are only brief irregularities in the growth pattern of revenues. One was the dramatic increase in public revenue collections in 1973 and 1974 (although this was largely at the national level). This was the time when the national government granted tax amnesties. Thereafter, the growth has not been as fantastic.

In sum both national and local patterns of growth fluctuated although there had mostly been positive growth.

C. Composition of Revenue

Among tax revenue, non-tax revenue and public borrowings, tax revenue is still the major source of revenue of both national and local governments.

Local governments' resources are limited to tax and non-tax revenues; no public borrowings. Since 1972, the local government realized over 60% of its revenue from non-tax sources.

For the national government level, tax revenue is the biggest component of the total revenues with an average of 57.3%. Second and third are public borrowings with 34.3% and non-tax revenue with 8.4%, respectively.

Figure 1 clearly shows the nearly flat movement of local government revenue for the past thirty years. Clearly, increase in revenues were confined primarily to the national government. This only shows the inability of local governments to increase levels of revenue generation for the past three decades and gives a relatively dull picture of local finance.

D. Revenues, Price and National Income

Figure 7 depicts the trend in prices as shown by the consumer price index (CPI), the public revenues, and national income (NI). The index of growth indicates that increases in the CPI were over and above that of the total revenues. This indicates that the increases in revenues in current prices (see also Figure 2A and 2B) were rendered illusory by the high inflation rates.

Relative to the increases in national income, revenue growth rates are higher which reflects an increasing revenue effort.

V. INTERNATIONAL COMPARISONS

The present state of development of the Philippine economy is often given as a justification for the low tax performance. There is, for instance, the wide disparity of per capita income between the industrialized countries and developing countries, like the Philippines.

The per capita GNP of the Philippines in 1976 was US$370 which is 10 percent less than that of Japan, Asia's most industrialized country; and is 17 percent less than that of Singapore, ASEAN's most prosperous country.

In 1988, although the Philippine per capita GNP was relatively higher at US$630 compared to past performance, it dived to about 3% of Japan's and almost 7% of Singapore's GNP for the same year. Compared to Thailand, the Philippine GNP for 1988 is about 63% of the former's GNP for that year.

In terms of its per capita revenue, (US$63.30 in 1976), the Philippines has lower yield compared to Malaysia which in 1976 had U.S. $158.00. The ratio of per capita revenue to per capita GNP was at 21.9%, which means that on the average, the Malaysians were subjected to more taxation than the Filipinos. Some may argue that the state of the Malaysian economy could allow Malaysians to be subjected to more taxation. However, the perception is that the Philippines is still undertaxed.

Compared to Japan, the ratio of both per capita revenue and GNP was only 8.1% and the share of revenues from their NI was only 27.3%. the tax effort was one half times higher than the Philippines' and the former's per capita GNP was over thirteen (13) times bigger.

Meanwhile, taxes on income, profit and capital gains taxes levied on actual or presumptive net income of individuals, on profits of enterprises, and on capital gains, whether realized on land sales, securities or other assets are examples of direct taxes. For the low income economies, represented by Bangladesh and Indonesia, the latter has levels which belong to that of higher-income economies by having direct taxes of about 50% of total taxes, a characteristic not that of low and middle income countries. On the other hand, Singapore is behaving like the middle income economies with income and profits taxes of only above 20% in contrast to the over 50% for the high income countries.

Domestic taxes on goods and services which include general sales and turnover or value added taxes, selective excise on goods, selective taxes on services, taxes on the use of goods or property and profits of fiscal monopolies are classified as indirect taxes. In 1972, Bangladesh, Indonesia, the Philippines, Malaysia, Singapore and Japan were not far from each other in this category. However, in 1989, while Bangladesh and the Philippines

increase by about 10%, Malaysia and Japan's declined. It is noticeable that the high-income economies as represented by Singapore, United States and Japan, compared with the low and medium-income economies, have relatively very low domestic taxes on goods and services. The same is true for the taxes on international trade and transactions which include import export duties, profits of export or import monopolies, exchange profits and exchange. Meanwhile, other taxes which include employers' payroll or labor taxes, taxes on property and taxes not allocable to other categories has been for most countries below 10%. It is interesting to note that Bangladesh, Singapore and Malaysia have very high non-tax revenues which include fines, administrative fees, or entrepreneurial income from government ownership of property.

VI. ISSUES

A. Adequacy of Revenues and Tax Administration

One of the standard tests in evaluating revenues is adequacy. This is specially directed towards tax revenues. The patterns of revenue from 1960 to 1990, especially on tax revenue indicate that revenue has not been sufficient. These findings are corroborated by the study of Dr. Kintanar which was cited in Chapter 3. The trend during the period under analysis probably emphasizes the need to evaluate revenue from taxation as a major source of funding. As earlier discussed, there are limits to the amount of tax revenues our administrators can collect. Furthermore, inflation appears to be always one step ahead. The potentials offered by non-tax revenues are worth investigating. At present, these play a very minor role as indicated in the preceding analysis. If our best tax efforts continue to be inadequate, then the challenge is to examine other options relative to expenditures.

The upgrading of tax administration is as important as restructuring the tax system. Administrative improvements have a positive effect on revenue enhancement and distributional and resource allocation goals. [12] This is particularly true of measures aimed at minimizing tax evasion. In the Philippines, the failure to effect a tax administration reform has offset the good intent of structural changes.[13]

Of the tax reforms implemented, the VAT, in some ways, has been a major change. VAT "per se" promotes economic efficiency by eliminating the distortionary effect of input taxes but has also proven itself to be a virtual "money machine".

Preparatory stage which includes formulation and preparation for implementation is needed. In the case of Indonesia, tax analysts agree that their success of VAT is due to this. Revenue-wise, the Philippines was not as successful initially with the VAT because of administrative problems.

B. Implications on Progressivity and Equity

In Chapter 6, the issue of progressivity in taxation was discussed. It is an admitted fact that in the Philippines, as well as in most developing countries, indirect taxes account for a much larger share of tax revenue than direct taxes.

On the average, indirect taxes accounted for 74 percent of tax collections from 1960-1990 while direct taxes accounted for 26 percent. Figures from other studies vary because of the difference in data used for analysis. However, the trends are the same. There seems to be no relief from the burden of indirect taxes. Since 1960 to 1987 excluding 1973 which had the lowest share ever of 61 percent, indirect taxes had always been above 70 percent. In 1979, the share of indirect taxes posted the highest figure of 77 percent of total tax revenues against 23 percent for direct taxes. As of 1988, it declined to 69 percent versus 31 percent for direct taxes.

Several explanations why the indirect taxes tend to account for a larger share of tax revenues in less developed countries are offered. First, direct taxes are much easier to administer than direct taxes. They are simply added to the cost of a good or service and built into its cost. Second, there is less resistance to an indirect tax than to a direct tax. This is especially true for indirect taxes on basic necessities. While those affected by direct taxes can organize themselves into a bigger and more influential group to prevent the passage of any law imposing additional direct taxes, those who are affected by indirect taxes, usually the lower income groups are not even aware that they are burdened by such taxes, or that such taxes are being passed on to them. Third, economic rigidities and fiscal politics in developing countries make it difficult to legislate increases in direct taxes.

Nevertheless, the constitutional commitment to progressivity in taxation must not be set aside. Furthermore, the avowed goal to redistribution of income and wealth through taxation must balance with other priorities. After all, redistribution of income and wealth is an essential component of "true" development which all developing countries aspire for.

In the 1986 Philippine tax reform programs, equity has been one of the stated goals. Discrepancies between policy objective and policy result were, however, observed. Manasan (1990) cites that the changes in the individual income tax should make the tax more progressive, in principle. But the failure of the government to minimize tax evasion by imposing ceilings on tax deductions made this unlikely. On the other hand, the introduction of the VAT and the restructuring of the petroleum product taxes, most especially the elimination of the tax on fuel oil, has lessened the tax burden on the poor.[14]

The lowering of the schedule of marginal tax rates for personal income, is not going to make the tax less progressive if it is accompanied by broadening measures as in Thailand and Indonesia. This is because in most ASEAN countries the top rates in their tax system apply to a segment of the population that is practically insignificant. In addition, high tax rates encourage evasion. Furthermore, income sources that were previously excluded from base weigh heavily in the total income of higher income groups. [15]

C. Borrowings in National Revenues

In Philippine fiscal administration, borrowings are considered revenues. These are accordingly reflected in financial statements. The increasing share of borrowings in national revenues should be of serious concerns to students of public debt in developing countries, including those who advocate public borrowing. From 1960-90, borrowing accounted for an average of 28 percent of total revenues. It was lowest in 1966 at only 0.8 percent of total revenues. Starting 1970, it remained over 30 percent except in 1985 and 1988 when it went back to below 30 percent. It peaked in 1987 at 53 percent.

If government corporations are included, the proportion might be much bigger. Since "development" corporations are in the forefront of borrowing activities.

As a consequence, the government is spending a large portion of its budget on debt-servicing which means smaller allocations for essential expenditure items such as education, health and public utilities, among others.

This trend signals a warning to keep borrowing activities within manageable levels. While borrowing is admittedly a powerful tool for fiscal policy, it can be dangerous as well. The rapid upward trend in borrowing also serves to reemphasize the issues brought out in Chapter 3 (Development Finance) and Chapter 13 on Public Debt.

D. Inflation and Revenues

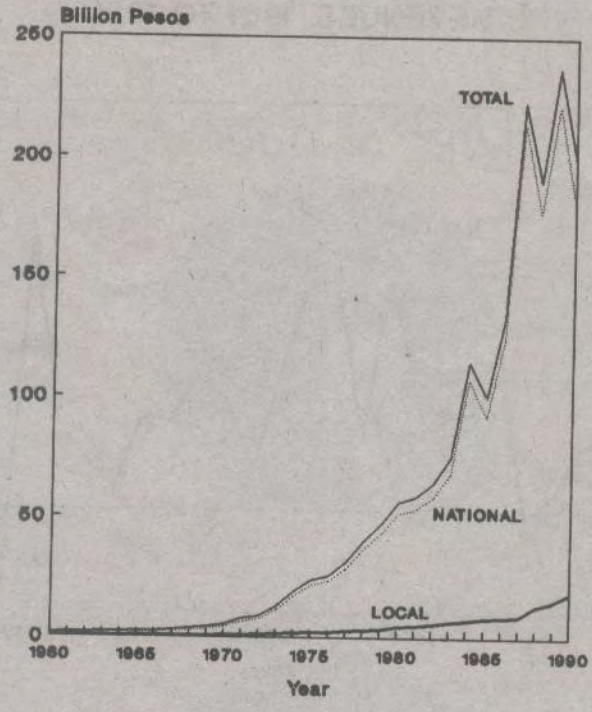
Another issue that has surfaced in this study on patterns of revenue from 1960 to 1990 is the pervasive role of inflation. While absolute growth of revenue registered at 519% at current rates, growth in real terms registered only at 79%. This probably means that inflation accounted for much of the dramatic increases in revenue. The latter, which is considered one of the impressive achievements of fiscal administration during this period may have been largely illusory. Perhaps, this explains why tax revenues could never catch up with expenditures. A second equally serious implication is that tax administration may not have played as great a role in the revenue increases

as popularly assumed. A third implication is the possibility that inflation during this period was much, much higher than officially admitted.

The above trend indicates a need to reexamine further the success in tax collection during this period. This is not to demean the efforts exerted by our fiscal administrators. The relationship between inflation and revenues need further looking into. Perhaps investigations could be directed towards identification of groups of taxes which were least ravaged by inflation. This could help continuing efforts to increase not only absolute revenue in current terms but also in real terms.

FIGURE 1. TOTAL PUBLIC REVENUES

AT CURRENT PRICES



AT 1972 PRICES

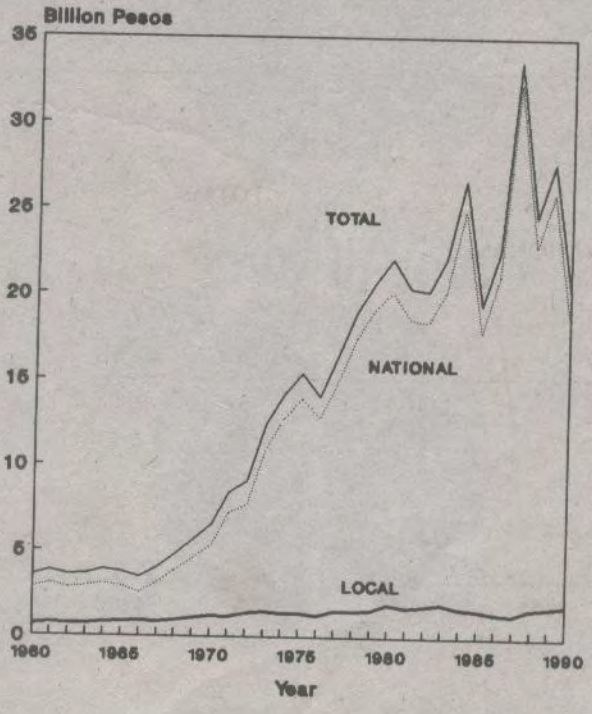


FIGURE 2A. PERCENT GROWTH OF PUBLIC REVENUES, 1961 TO 1990

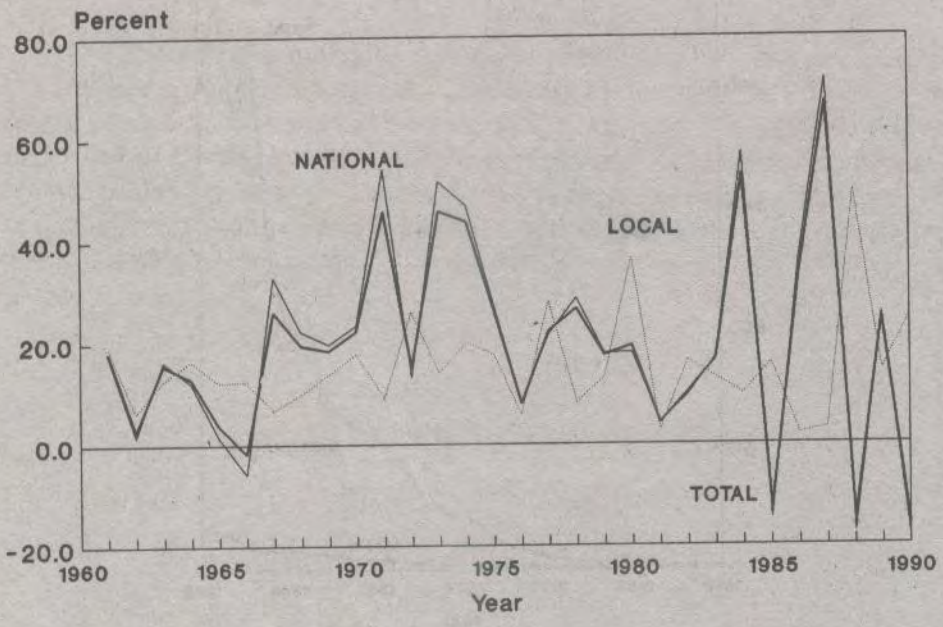


FIGURE 2B. REAL GROWTH OF GOVERNMENT REVENUES BY LEVEL OF GOVERNMENT

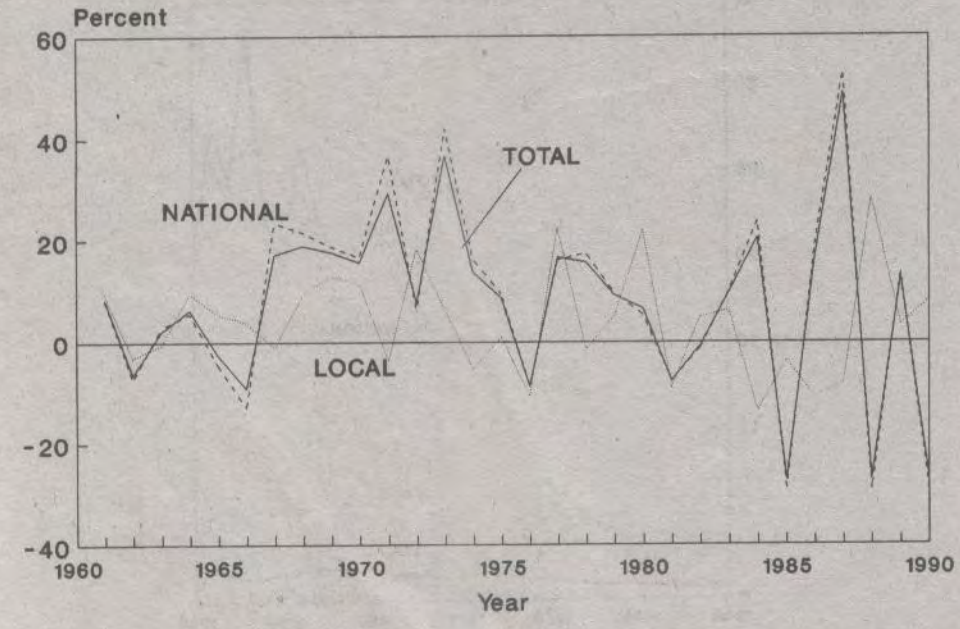


FIGURE 3. AVERAGE REVENUES BY LEVEL OF GOVERNMENT

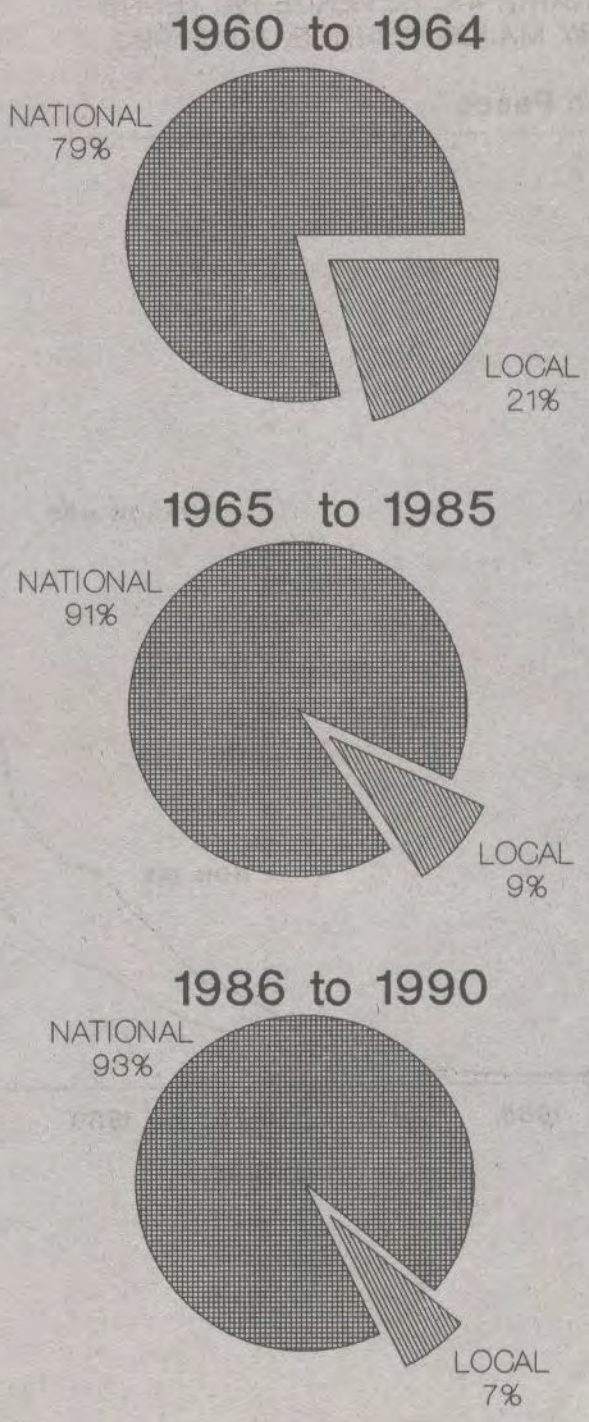


FIGURE 4A. REVENUE PATTERNS
BY MAJOR SOURCE, 1960-1990

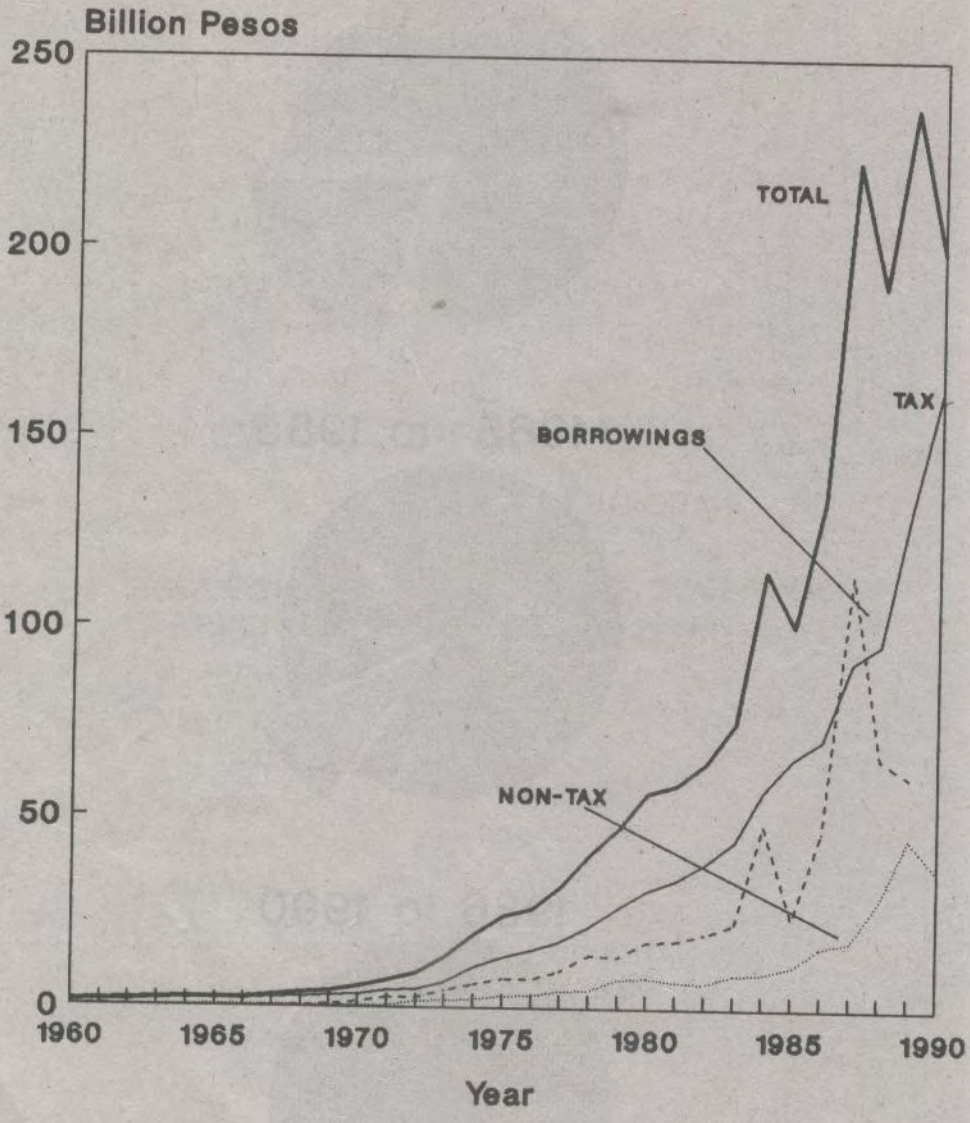


FIGURE 4B. NATIONAL REVENUES
BY MAJOR SOURCE, 1960-1990

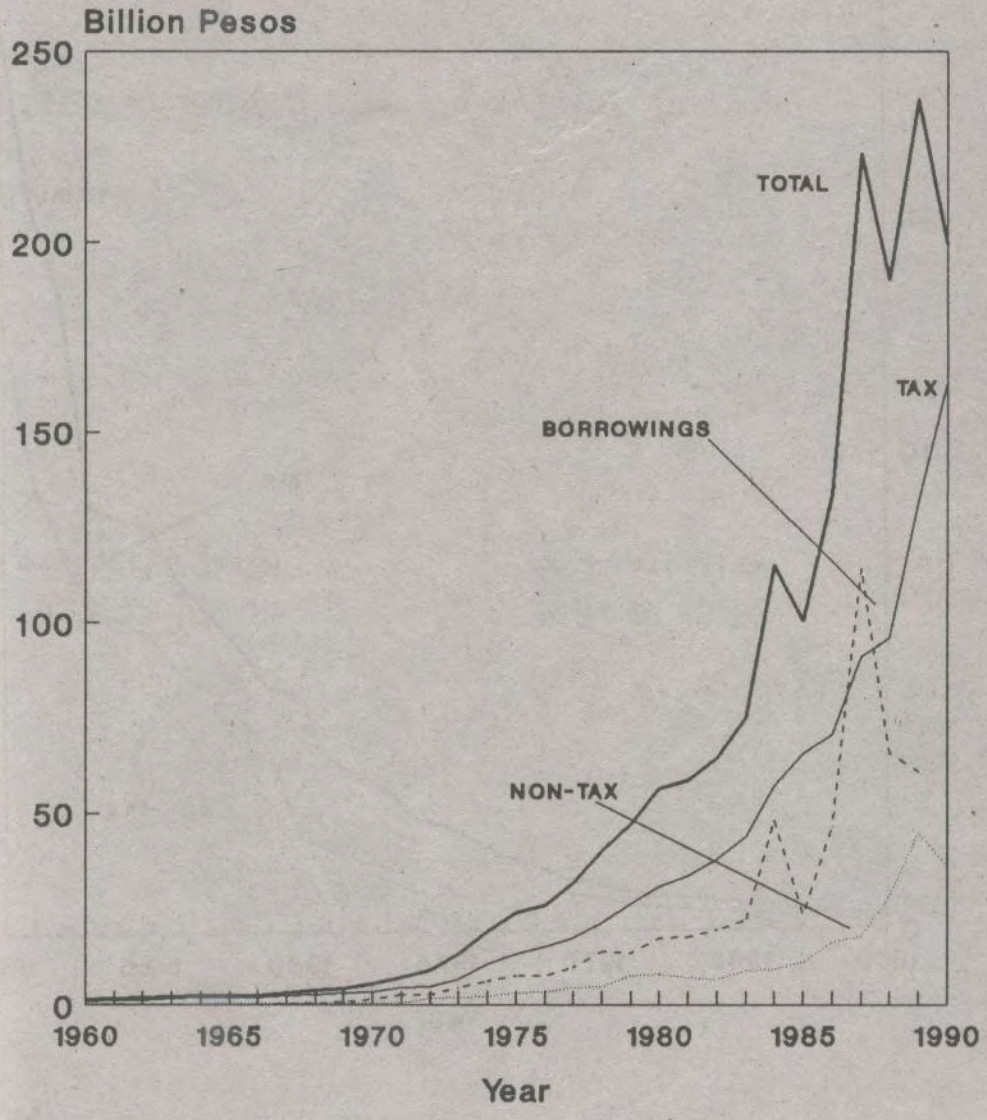


FIGURE 4C. LOCAL REVENUES
BY MAJOR SOURCE, 1960-1990

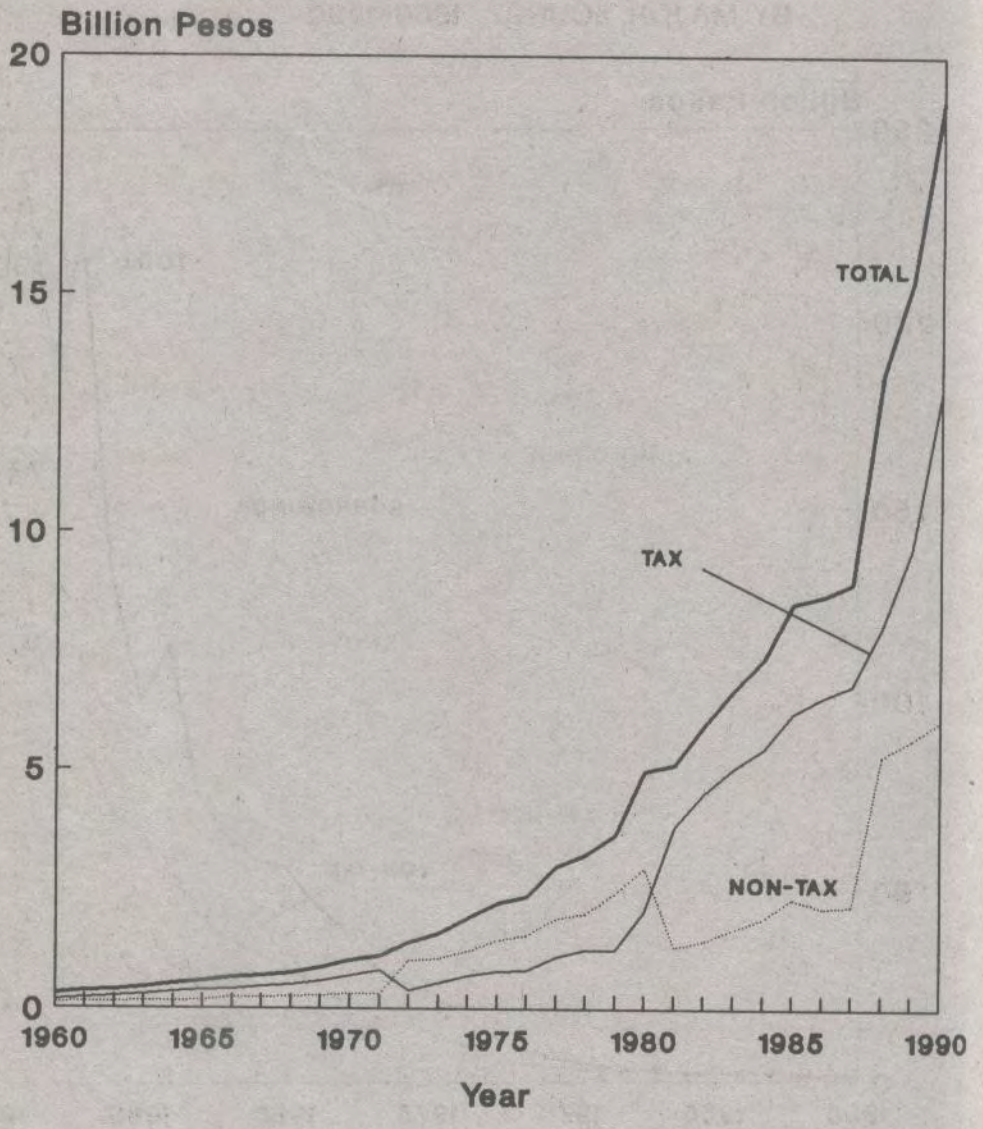


FIGURE 5. AVERAGE GOVERNMENT REVENUES

PRE-MARCOS, MARCOS YEARS & POST MARCOS YEARS

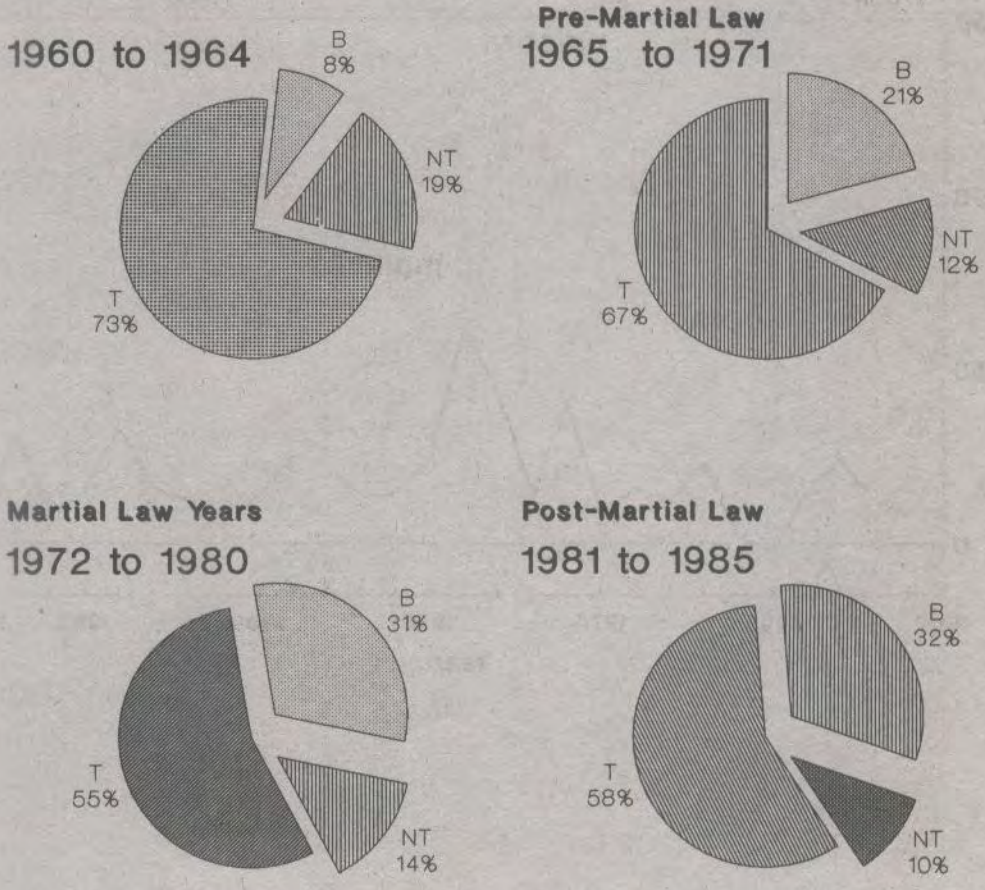


FIGURE 6. PERCENT GROWTH OF NATIONAL TAX REVENUE BY TYPE

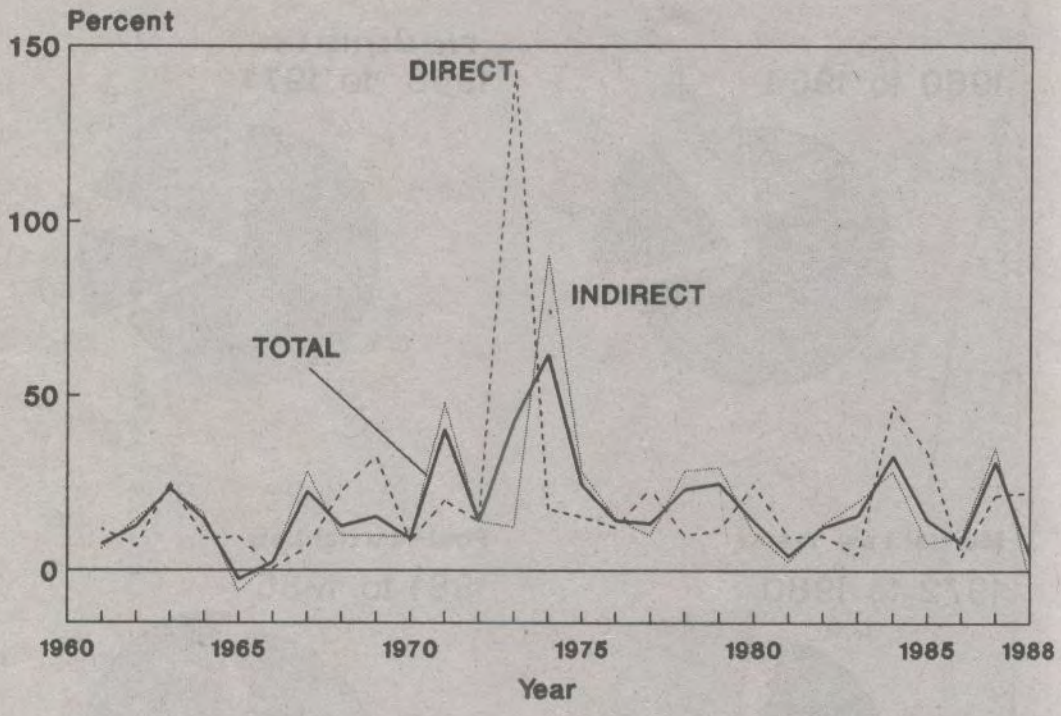
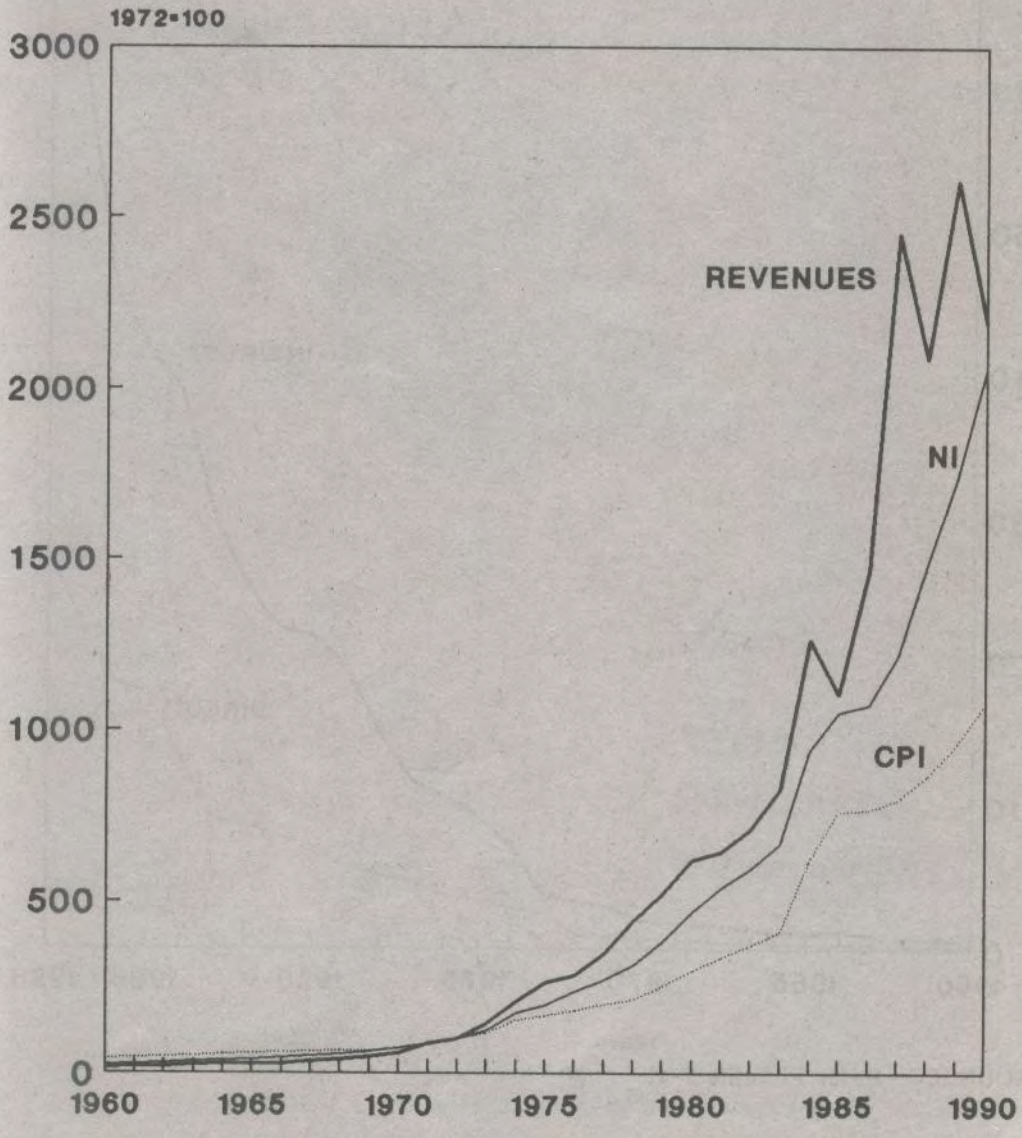
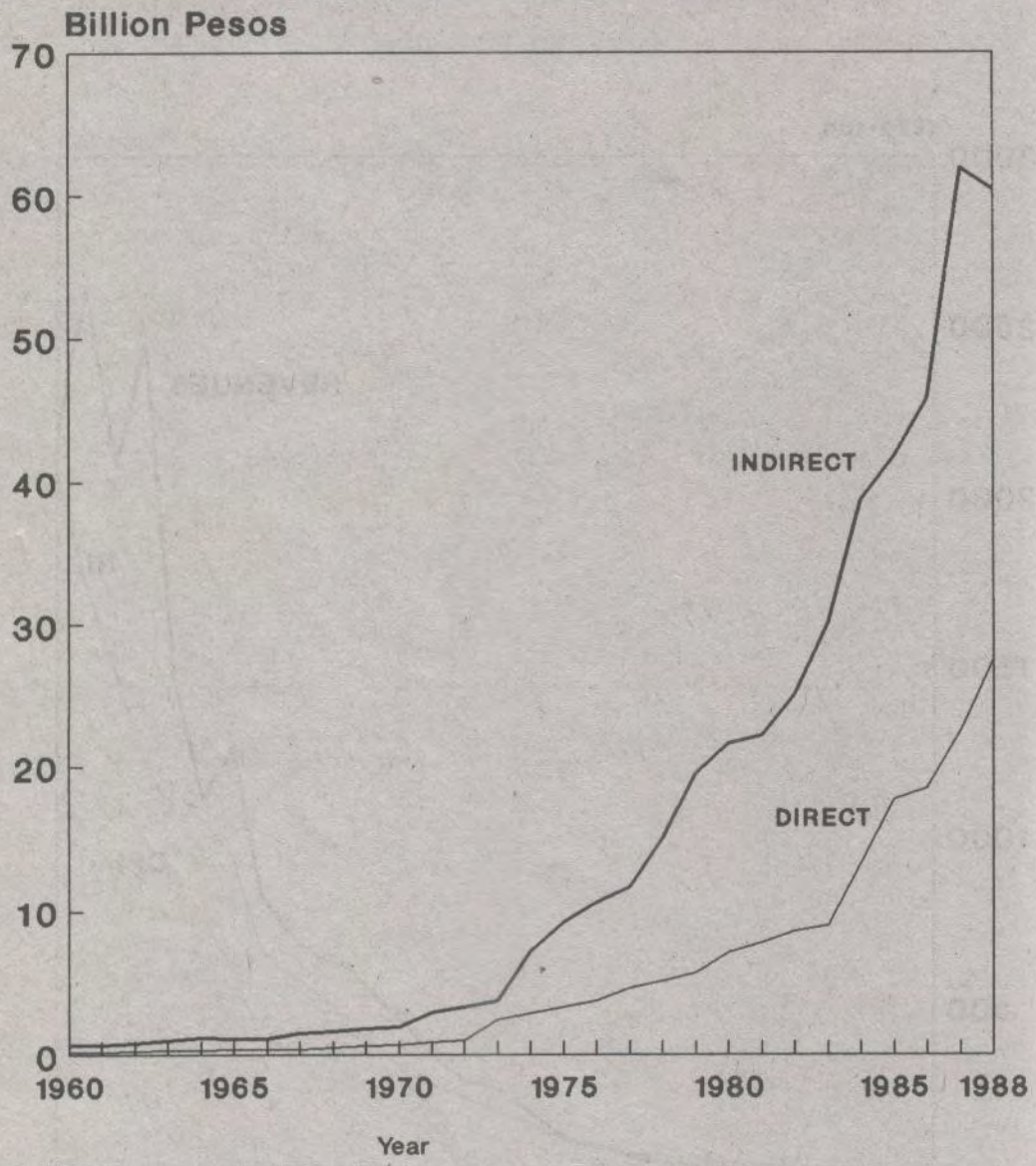


FIGURE 7. INDECES OF TOTAL REVENUES, NATIONAL INCOME AND CPI



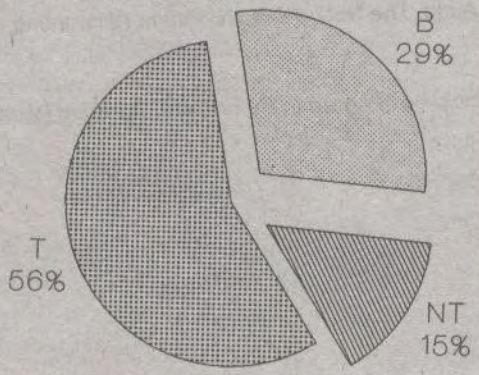
SOURCES: For CPI and NI: NEDA.
For Revenues: Refer to Table 7-3.

FIGURE 8. NATIONAL GOVERNMENT TAX REVENUES BY KIND OF TAX



SOURCES: Refer to Table 7-11.

Aquino Years
1986 to 1990



Legend:

T=Tax

NT=Non-Tax

B=Borrowings

Donated by:

MASTER OF PUBLIC ADMINISTRATION
ASSOCIATION, INC.

ENDNOTES

[1]World Bank. World Development Report 1991.

[2]*Ibid.*

[3]Amalia Abello, *Pattern of Public Expenditures and Revenue*,(Quezon City: University of the Philippines Institute of Economic Development and Research), p. 32.

[4]Commission on Audit. The National Government Accounting Manual (Quezon City: COA), p. 15.

[5]Jose Nolledo, *Principles of Agrarian Reform and Taxation* (Manila: Rex Publications, 1972), p. 132.

[6]*Ibid.*

[7]*Ibid.*

[8]Briones, 1988.

[9]Abello, 1964.

[10]Manasan, R., " Financing Public Sector Development Expenditure in Selected Countries," Philippines, Manila; Asian Development Bank, June 1988.

[11]Amelia Abello, *op cit.*, pp. 50-57.

[12]Manasan, R., "A Review of Fiscal Reforms in ASEAN Countries in the 1980s," PIDS Working Paper 90-14, 1990, p. 26.

[13]*Ibid.*

[14]Manasan, R., "Management of Public Enterprises: The Case of the Philippines," paper presented at the 1990 ADB Roundtable Conference, Seoul, South Korea, Aug. 22-25, 1990 as cited in PIDS Working Paper 90-14, p. 25.

[15]*Ibid.*

CHAPTER 8

FINANCING PHILIPPINE LOCAL GOVERNMENTS

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FINANCING PHILIPPINE LOCAL GOVERNMENTS

INTRODUCTION

This chapter highlights the relevant provisions of the 1991 Local Government Code. It primarily deals with the financial aspects of Philippine local governments as provided for in the revised Code particularly on administration, expenditures, and the overall management of fiscal affairs. The issues and problems that had beset the local governments and are foreseen with the passage of the new law with regard to strengthening the capability of local governments are also discussed.

I. THE LOCAL GOVERNMENT SYSTEM

As defined by the United Nations, a local government is a political unit of a nation or state constituted by law with power of control over local affairs including the power to impose taxes.[1] Its functions and scope of activities in relation to the central government are characterized by centralism, hierarchical structure, chain of command, executive dominance and legislative legislation.[2] The central government however has full power of control and supervision over all political and administrative units and subdivisions.[3] A local government unit is regarded as a "subordinate branch of the government of the State," while local government administration is considered as "an instrumentality of state administration."[4]

> *"It exercises delegated powers of government. Its charter is granted for the better government of the particular areas or districts. It is a political division of the state and variedly described as an arm of the state, a miniature state, an instrumentality of the state, a mere creature of the same, an agent of the state and the like."*[5]

A local government unit "is established by law partly as an agency of the state to assist in the civil government of the country, but chiefly to regulate and administer the local or internal affairs of the city, town," provinces and barangays.[6] The purposes of local government units are, therefore, dual:

1. to serve as an agency or instrumentality of the state [National Government] in carrying on the functions of government which the state cannot conveniently exercise, such as the collection of taxes, assessment of property, and enforcement of police regulations; and

2. to act as agency of the inhabitants of the community in the regulation and the operation of municipal franchises and public utilities, the promotion and management of their local affairs, such as maintenance of water system, ferries, wharves x x x x;"[7] including, but not limited to roads and bridges, and operation of public markets, and other activities relevant to the local existence.[8]

As of 1990 there were 75 provinces, 60 cities, more than 1,537 municipalities and 40,832 barangays.[9] Since then, Guimaras, Saranggani and Biliran were added to the roster of provinces. Note that while the Constitution provides for autonomous regions, it is cautious enough not to include them in the enumeration of territorial and political subdivisions.[10] It appears, therefore, that autonomous regions are, technically, not territorial and political subdivisions contemplated for purposes of Constitutional provisions on local governments. In fact, autonomous regions are governed by organic acts and not by laws governing local governments, except in suppletory character.

Sub-provinces were given 10 years from the effectivity of the old Local Government Code (BP 337) in 1983 within which to meet the minimum requirements to qualify as provinces, otherwise the component cities and municipalities revert back to their mother provinces.[11]

Under the new Code, sub-provinces are deemed converted into regular provinces upon approval in the plebiscite held in sub- provinces and provinces directly affected.[12] The Constitution also takes cognizance of special metropolitan subdivisions where central direction is limited to basic services requiring coordination; the component cities and municipalities retain their basic autonomy and their own local executives and legislative assemblies.[13]

The largest local government unit under existing jurisprudence, is the province (lalawigan). A province is further subdivided into cities (lunsod)[14] and municipalities (bayan). The smallest units, under the jurisdiction of the cities and municipal governments, are barangays. The set up of these political units are described below.

A. *The Provincial Government*

Under the Local Government Code "the province serves as a dynamic mechanism for developmental processes and effective governance of local government units under its territorial jurisdiction."[15] The minimum requirements for the creation of a province are: (1) law of creation; (2) approval by local government units directly affected in a plebiscite; (3) average annual income of not less than P20 Million (1991 constant prices); and (4) either of the following: (4.1) 2,000 sq. km. contiguous area, or (4.2) 250,000 inhabitants.[16]

The provincial chief executive is the Governor, and the provincial legislature is the *Sangguniang Panlalawigan.* The *Sanggunian* is composed of the vice-governor who is automatically the presiding officer, regular members who are directly elected, president of the provincial *liga ng mga barangay*, president of *panlalawigang pederasyon ng mga sangguniang kabataan*, president of the provincial federation of sanggunian members of municipalities and component cities, and three sectoral representatives.[17] (See Chart 1 below).

Chart 1. Sangguniang Panlalawigan

VICE-GOVERNOR Presiding Officer

SANGGUNIANG PANLALAWIGAN MEMBERS				
REGULAR MEMBERS	PRESIDENT PROVINCIAL CHAP. LIGA NG MGA BARANGAY	PRESIDENT PANLALAWIGANG PEDERASYON NG MGA SANGGUNIANG KABATAAN	PRESIDENT PROV. FED. OF S. BAYAN MEMBERS OF MUNICIPALITIES AND COMPONENT CITIES	SECTORAL REPRE-SENTA-

The other principal officials of the provincial government more directly involved in local government finance are the provincial treasurer, the provincial assessor, the provincial budget officer, the provincial accountant, and the provincial planning and development coordinator.[18] The provincial treasurer, placed under the administrative supervision of the Governor, is appointed by the Secretary of Finance from among at least three recommendees of the Governor.[19]

B. *The City Government*

The city is made up of more urbanized and developed barangays.[20] It "serves as a general purpose government for the coordination and delivery of basic, regular and direct services and effective governance of the inhabitants within its jurisdiction."[21] The basic requirements for creation of a city are: (1) law of creation; (2) approval of voters in a plebiscite; (3) average annual income of P20 Million; and, (4) either of the following: (4.1) 100 sq. km. contiguous territory, or (4.2) 150,000 inhabitants.[22] Special types of

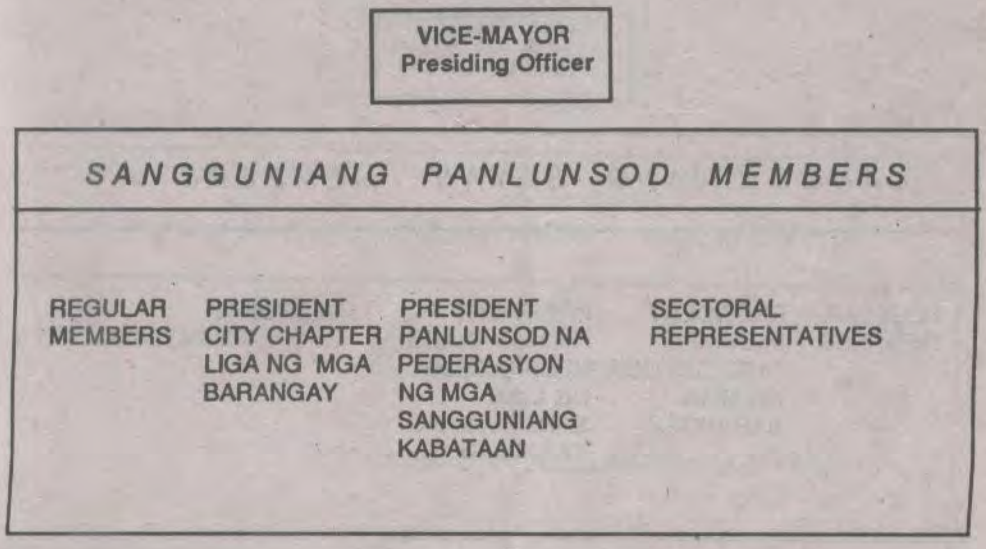
cities are independent component cities and highly urbanized cities. Independent component cities, which are independent of provinces, have charters that disallow their voters from electing provincial officials.[23] Highly urbanized cities have at least 200,000 inhabitants and annual income of at least P50 Million (1991 prices).[24] They are also independent of provinces and their voters do not elect provincial officials.[25] The Constitution provides that highly urbanized cities and component cities whose charters (laws creating them) prohibit their voters from voting for provincial elective officials are independent of the province.[26]

The chief executive of the city is the city mayor. Among major duties, he enforces national laws and city ordinances, and submits the annual budget of the city to the Sangguniang Panlunsod.[27]

The Sangguniang Panlunsod is the legislative body of the city. It is composed of the vice-mayor who automatically becomes the presiding officer, regular members who are directly elected, president of the city *Liga ng mga Barangay*, president of *Panglunsod na Pederasyon ng mga Sangguniang Kabataan*, and three sectoral representatives.[28] (See Chart 2 below).

Among leading officials primarily involved in fiscal matters are the treasurer, assessor, accountant, budget officer, and planning and development coordinator.[29] The treasurer, placed under the administrative supervision of the Mayor, is appointed by the Secretary of Finance from among at least three recommendees of the Mayor.[30]

Chart 2. Sangguniang Panlunsod



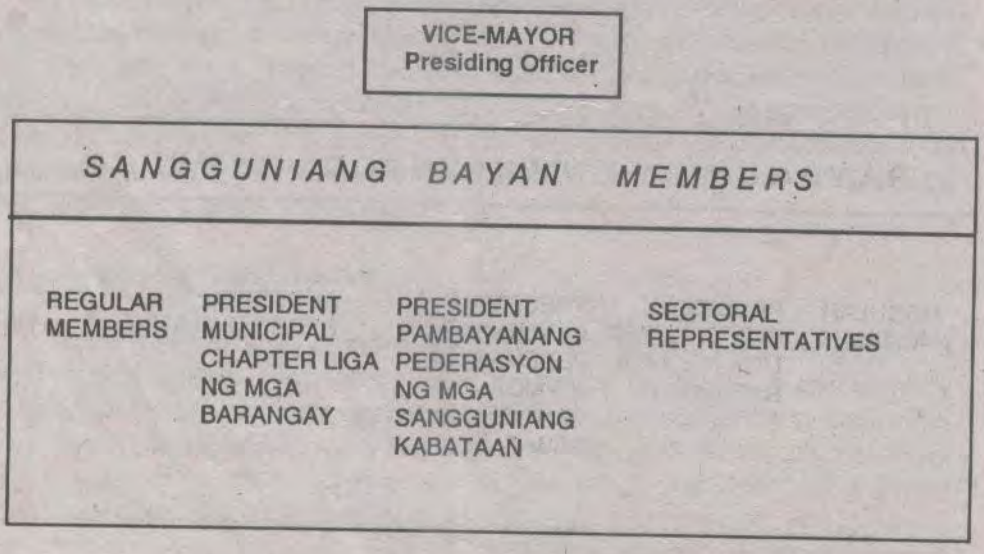
C. *The Municipal Government*

The municipality or town is composed of barangays which are less urbanized and developed than city barangays. It "serves primarily as a general purpose government for the coordination and delivery of basic, regular and direct services and effective governance of the inhabitants within its jurisdiction."[31] Basic requisites for creation of a municipality are: (1) charter or law creating it; (2) approval by voters of units directly affected in a plebiscite; (3) average annual income of at least P2.5 Million (1991 constant prices); (4) 25,000 inhabitants; and (5) 50 sq. km. contiguous territory.[32] Existing municipal districts created under presidential issuances with incumbent officials at the effectivity of the new Code are deemed regular municipalities.[33]

The chief executive of the municipal government is the municipal mayor while the *Sangguniang Bayan* is the municipal legislature. The *Sanggunian* is composed of the vice-mayor who is automatically the presiding officer, the regular members who are directly elected, president of the municipal *Liga ng mga Barangay,* president of *Pambayanang Pederasyon ng mga Sangguniang Kabataan,* and three sectoral representatives.[34]

Other officials more directly involved in local government finance are the treasurer, assessor, accountant, budget officer, and planning and development coordinator.[35] The treasurer, placed under the administrative supervision of the Mayor, is appointed by the Secretary of Finance from among at least three recommendees of the Mayor.[36]

Chart 3. Sangguniang Bayan



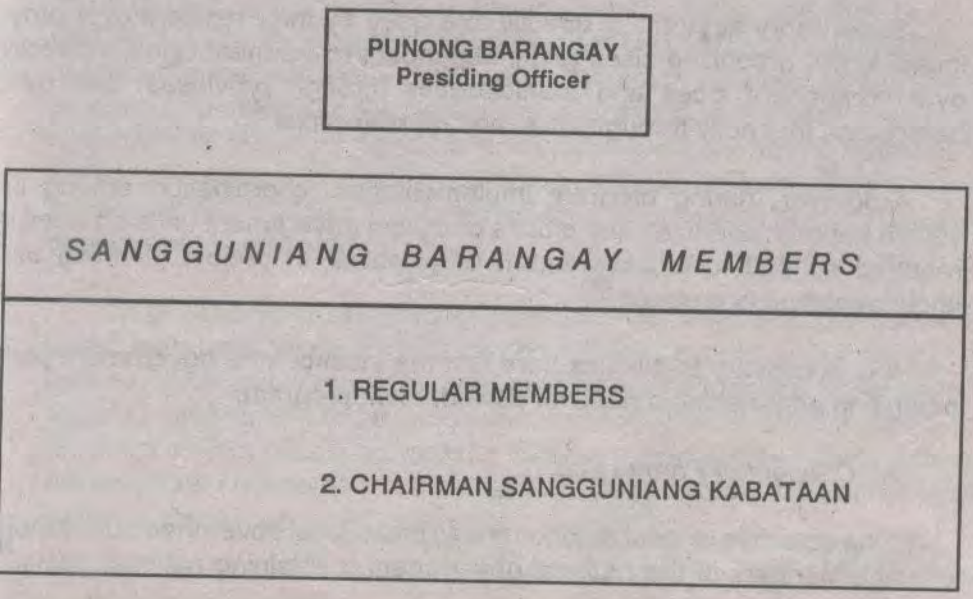
The Barangay

The *barangay* is the basic government unit in the political structure. It serves both as "primary planning and implementing unit of government policies, plans, programs, projects and activities in the community, and as a forum in which the collective views of the people may be expressed, crystallized and considered, and where disputes may be amicably settled."[37] The minimum requirements for the creation of a barangay are: (1) law or ordinance of *Sangguniang Panlalawigan*[38] or *Sangguniang Panlunsod* creating it; (2) approval by units directly affected in a plebiscite; (3) a contiguous territory; and (4) a population of at least 2,000 inhabitants.[39]

The *barangay* is the base of the citizen's participation in government affairs. It serves as the forum for popular democracy through the operations of the *Barangay Assembly.*[40]

The *punong barangay* or the *barangay* captain is the chief executive of the *barangay* and the *sangguniang barangay* is the legislature. The *sanggunian* is composed of the *punong barangay* who automatically is presiding officer, regular members who are directly elected, and the *sangguniang kabataan* chairman.[41] The main fiscal official of the barangay is the treasurer. He is appointed by the *punong barangay* subject to concurrence of the majority of the *sangguniang barangay* members.[42] See Chart 4 below.

Chart 4. Sangguniang Barangay



II. INTERGOVERNMENTAL RELATIONSHIP

National and local governments are not on equal footing. Local governments owe their existence to Congress and they are placed under the general supervision of the President. More importantly, they only wield powers delegated to them by the national government. Local governments are, therefore, considered inferior. But this comparison does not lessen the practical importance of devolving power to them. In this way, more people participate in government and the national government is freed from or unloaded of more localized concerns.

The power of Congress is not unlimited nor unrestricted. Consistent with the policy of local autonomy, the Constitution requires Congress to pass not just any law devolving power to local governments but one which provides, among others, "for a more responsive and accountable local government structure instituted through a system of decentralization."[43] Corollarily, the Constitution empowers local governments to create revenue sources, including power to tax and collect fees and charges which exclusively accrue to them.[44] Being constitutionally vested, local governments cannot be deprived of this power by Congress. The revenue generating power is, however, subjected to "guidelines and limitations as the Congress may provide, consistent with the basic policy of local autonomy."[45]

The President exercises general supervision over local governments.[46] Supervision is authority to "ensure that their (local government units') acts are within the scope of their prescribed powers and functions."[47] The President, however, cannot reverse nor modify any act of the local government as long as it is within legal limits.

Supervisory authority is directly exercised by the President over provinces, highly urbanized cities and independent component cities; indirectly over component cities and municipalities *through provinces*; and over *barangays,* indirectly through cities and *municipalities.*[48]

Moreover, during program implementation, coordination among involved national agencies and offices and local government units affected is required so that local government participation in project planning and implementation is ensured.[49]

It is necessary to discuss here first the local-central government partnership in undertaking a national development program.

A. *Concept of Partnership*

One objective of local autonomy is to make local government units more effective partners of the national government in attaining national goals.[50]

The concept of partnership is based on the assumption that in as far as national development is concerned, neither the national nor local governments can "do it alone." In the process of nation-building, national and local institutions should work in a concrete and unified effort on integrated programs of local and national concerns. The partnership scheme, in essence, is sharing of responsibilities which may be operationalized by using the four dimensions in the administration of any development program (planning, financing, implementation and evaluation) as the criteria for determining the specific nature of involvement that may be assigned to each government.[51]

Generally, the planning phase of the program is the primary responsibility of the central government. This phase includes determination of priorities, analysis and integration of data inputs from the local units, systematic allocation of resources, setting guidelines and policy standards, and actual formulation of the plan.

In an attempt to give importance to local government planning, it is provided that:

> *"National planning shall be based on local planning to ensure that the needs and aspirations of the people as articulated by the local government units in their respective local development plans are considered in the formulation of budgets of national line agencies or offices."* [52]

However, in relation with other provisions, it appears that in order that policies, programs and projects proposed by local development councils may merit consideration and be included by the national government in development plans, they must first compete to be integrated with the development plans of next higher level local development councils, until they reach the NEDA.[53] It is only then that they are taken into account in the formulation of the budget of national line offices.[54] Moreover, even those projects and programs undertaken by local governments alone, as contained in their respective local budget plans and goals, have to be harmonized with national development plans in order to optimize and avoid duplication in utilization of government resources.[55] This requirement stresses the primacy of national government in planning.

The financing phase of most programs may be a shared responsibility through an arrangement which can be effected through a number of alternatives. The principal and regular funding of projects may come from the national government but fixed contributions may be exacted from the local units. In certain cases, the greater funding requirements may be borne by the local units but some grants and subsidies may require an equal sharing between the national and local governments.[56]

Finally, all the financial affairs of local governments are audited by the Commission on Audit of the central government.[57]

As a rule the local government budget is reviewed by the sanggunian of the next higher level unit. Hence, the budget of the barangay is passed upon by the respective sangguniang bayan or *panlunsod*, and that of a municipality or component city by a *sangguniang panlalawigan.*[58] However, that of a province, or a highly urbanized city, or an independent component city, or a Metro Manila municipality is reviewed by the Department of Budget and Management.[59]

Both levels of government may have to do the evaluation of a program for their own purposes. The national government has to devise a control system to get assurance that in the implementation, minimum standards are met, legal requirements and policy guidelines are observed, and technical support is adequate. The local governments' part of the evaluation task is designed to ascertain the responsiveness of the program and assess its concrete impact on the people of the community.[60]

B. *Planning for Development*

The declared policy that the socioeconomic development of the various regions within the country will be promoted by undertaking regional planning at the national level and specific planning and programming at the local level led to the creation of regional councils. In fact, their creation is expressly mandated by the Constitution, thus,

> *"The President shall provide for regional development councils or other similar bodies composed of local government officials, regional heads of departments and other government offices, and representatives from nongovernmental organizations within the regions for purposes of administrative decentralization to strengthen the autonomy of the units therein and to accelerate the economic and social growth and development of the units in the region."*[60a]

These regional councils shall maintain close coordination with the National Government and planning boards of local governments. Among others, they translate the national economic goals into more specific regional objectives which are reflected in plans and programs of action prepared for the region. They also coordinate and integrate all planning activities of the local governments and local planning boards in the region for consideration of the National Economic Development Authority (NEDA).

III. LOCAL GOVERNMENTS' FISCAL STRUCTURE

A. *Fund Structure*

The local governments' fund structure is established under the Local Government Code. Under said law, each local government, including the *barangay*, maintains a General Fund which comprises monies and resources of the local government available for payment of expenditures, obligations or purposes not specifically declared by law as chargeable to other funds.[61]

Within the General Fund, special accounts are maintained for (a) public utilities and economic enterprises, (b) loans, interests, bond issues, and contributions for specific purposes, (c) development projects funded from internal revenue allotment and special accounts created by law or ordinance.[62]

Special Funds are constituted only by municipalities, cities and provinces (not including *barangays*). These funds are the Special Education Fund (SEF) and Trust Funds. The SEF consists of shares of all local government units in the proceeds of additional tax on real property allocated exclusively for operation and maintenance of public schools, construction and repair of school buildings, facilities and equipment, educational research, purchase of books and periodicals and sports development.[63]

Trust Funds are public and private monies which officially come into possession of the local government or of its official as trustee, or that which are received as guaranty for fulfillment of an obligation.[64]

B. *Major sources of Revenues*

Local revenues are derived mainly from two sources: (1) allotments and aids from the national government and (2) local taxes, fees and charges.

1. *National Allotments and Aids*

The local government's just share in national taxes is constitutionally conferred.[65] The amount is determined by law (Local Government Code) and released automatically.[66] The allotment is taken from national internal revenue taxes (generally those taxes collected by the BIR) equivalent to 40 per cent of collections.[67] However, the allotment may be reduced down to 30 % "in the event that the national government incurs an unmanageable public sector deficit" as determined by the President.[68] The cost of devolved functions for essential public services is deemed included in the allotment.[69]

Also accorded by the Constitution is the equitable share of local government units in the proceeds of utilization and development of national wealth inside their respective territories.[70] The process which is provided by law (Local Government Code) includes sharing direct benefits with inhabitants.[71] The share of local government units is set at 40 % of collections of the national government from mining taxes, royalties, forestry and fishery charges, and other taxes, fees, or charges, related surcharges, interests or fines, and of the share of the national government in co-production, joint venture or production sharing agreement in utilization/development of national wealth.[72]

In addition, local government units also share from the proceeds of any government agency or government-owned or controlled corporation (GOCC) derived from utilization and development of national wealth located in their respective areas.[73]

Proceeds from the foregoing collections is directed to be spent to finance local development and livelihood projects.[74] However, where proceeds are derived from utilization and development of energy sources (hydrothermal, geothermal, etc.), 80 % of the proceeds should be applied exclusively to reduce power cost in the unit where the energy source is located.[75]

a. National Internal Revenue Allotment

The apportionment is as follows:[76]

Provinces	-	23 %
Cities	-	23 %
Municipalities	-	34 %
Barangays	-	20 %

Cognizant that the economic standings of local government units vary, it is further provided that each province, city and municipality should receive their respective share on the basis of the following formula:[77]

Population	-	50 %
Land Area	-	25 %
Equal Sharing	-	25 %

Sharing among barangays is based on the following: [78]

(1) Those with a population of at least 100 inhabitants shall receive at least P80,000.00.

(2) All others receive the balance to be shared based on the following formula:

On the first year of the effectivity of this Code:

Population -	40 %
Equal sharing -	60 %

On the second year:

Population -	50 %
Equal Sharing -	50 %

Thereafter:

Population -	60 %
Equal sharing -	40 %

The financial requirements of barangays created by local government units after the effectivity of this Code are borne by the latter.

b. Share in National Wealth (In General)

In addition to the internal revenue allotment, we mentioned that local governments are entitled to a 40% share of the government's collection from mining taxes, royalties, forestry and fishery charges and other charges on, and co-production agreements of, national wealth within their territories.[79]

c. Share in National Wealth (By Government Agency or GOCC)[80]

The share of local governments is based on any of the following schemes whichever produces a higher share for the local government:

(1) one percent of gross receipts of preceding calendar year; or,

(2) 40 percent of mining taxes, royalties, forestry and fishery charges, and other taxes, fees or charges, related surcharges, interests, or fines the government agency or GOCC would have paid if it were not otherwise exempt.

Distribution is as follows:

(1) If the source of wealth is located in a component city or municipality:

Province	-	20 %
Component City\ Municipality	-	45 %
Barangay	-	35 %

Where located in two or more provinces, or component cities or municipalities or *barangays,* sharing is computed base on the following formula:

Population	-	70 %
Land Area	-	30 %

(2) If the source is located in highly urbanized or independent component cities:

City	-	65 %
Barangay	-	35 %

Where the source is located in two or more cities or barangays, sharing is computed based on the following scheme:

Population	-	70 %
Land Area	-	30 %

d. Other Revenue Sources

Aside from the regular allotments, local government units also receive other forms of aid from the national government funds such as those from the Philippine Charity Sweepstakes, Horse Race and Lotteries.

2. *Local Levies*

Local levies are generated through the imposition of the real property tax formerly under PD 464 (Real Property Tax Code) and other impositions under PD 231 (Local Tax Code), now consolidated under the Local Government Code.

a. Local Government Tax

The following are levied by provinces:

(1) tax on transfer of ownership (donation, sale, barter) over real property;[81]

(2) tax on business of printing and publication;[82]

(3) franchise tax;[83]

(4) tax on gravel and sand and other quarry resources but proceeds distributed as follows: Province 30%; City/Municipality 30%; *Barangay* 40%;[84]

(5) annual professional tax (practice of profession requiring government examination);[85]

(6) amusement tax, to be divided equally by the province and municipality;[86] and

(7) annual fixed tax for delivery truck or van of manufacturers or producers, wholesalers , dealers or retailers of distilled spirits, fermented liquors, soft drinks, cigars, cigarettes, and products determined by the *Sangguniang Panlalawigan.*[87]

The following are levied by municipalities:

(1) business tax on wholesalers, distributors, dealers, manufacturers, assemblers, repackers, processors, brewers, distillers, rectifiers, compounders, exporters, millers, contractors, banks, financial institutions, peddlers and others;[88]

(2) fees and charges on business and occupation or practice of profession not reserved to the province;[89]

(3) fees for sealing and licensing of weights and measures;[90]

(4) fishery rentals, fees and charges;[91] and

(5) community tax paid by every resident at least 18 years old.[92]

Cities levy all taxes, fees and charges that may be imposed by the province or municipality. However, those levied by highly urbanized cities and independent component cities accrue exclusively to them.[93]

Barangays levy the following:[94]

(1) taxes on stores and retailers with fixed business establishments with gross receipts not exceeding P50,000 in cities and P30,000 in municipalities;

(2) fees and charges for services rendered in connection with regulation or use of barangay-owned properties or service facilities like *palay*, copra or tobacco dryers;

(3) clearance fees on license permit issued by city or municipality for business or any activity;

(4) fees and charges on commercial breeding of fighting cocks, cockfights and cockpits;

(5) fees and charges on places of recreation which charge admission fees; and

(6) fees and charges on billboards, signboards, neon signs, and outdoor advertisements.

Revenue raising powers common to all local government units are the following:[95]

(1) fees and charges for services rendered;

(2) charges for operation of public utilities owned, operated and maintained by them within their jurisdiction;

(3) toll fees and charges for use of public road, pier, wharf, waterway, bridge, ferry or telecommunications system funded and constructed by them; and

(4) any tax, fee, or charge on any base not mentioned by laws provided that (a) it is not unjust, oppressive, excessive, confiscatory, or contrary to national policy; and (b) public hearing shall be conducted.[96]

b. Real Property Tax

The real property tax is imposed by the local government on every land, building, machinery and other real property located within its territorial jurisdiction. Under the law, however, only provinces and Metro Manila cities and municipalities are made "primarily responsible for proper, efficient and effective administration" of the tax.[97] Respective *sanggunians* levy an annual *ad valorem* tax based on the *assessed value* of property. This is the reason why a system of assessment is an important step of real property taxation.

Real properties are categorized into residential, agricultural, commercial, industrial, mineral, timberland or special,[98] apparently for the purpose of fixing proportionately higher assessment levels for properties put into more productive use. Thus, assessment levels which are fixed by the

sangguniang panlalawigan and respective *sanggunian* of cities and municipalities of Metro Manila should not exceed the following ceilings:[100]

(1) On Lands:

CLASS	ASSESSMENT LEVELS
Residential	20%
Agricultural	40%
Commercial	50%
Industrial	50%
Mineral	50%
Timberland	20%

(2) On Buildings and Other Structures:

Residential. Minimum of 0% if fair market value (FMV) is lower than P 175,000 to maximum of 60% if FMV is over P10 Million.

Agricultural. Minimum of 25% if FMV is below P300,000 to maximum of 50% if FMV is over P2 Million.

Commercial/Industrial. Minimum of 30% if FMV is below P300,000 to maximum of 80% if FMV is over P10 Million.

Timberland. Minimum of 45% if FMV is below P300,000 to maximum of 70% if FMV is over P2 Million.

(3) On Machineries: 40% for agricultural, 50% for residential, and 80% for commercial and industrial.

(4) On Special Classes: Assessment level for all kinds of real properties, i.e., lands, buildings, machineries, and other improvements, are uniform if actual use is for any of the following considerations:

PURPOSE	ASSESSMENT LEVEL
Cultural	15%
Scientific	15%
Hospital	15%
Local Water Districts	10%
Government Corporations engaged in Water and Electric Power Supply	10%

Fixing of assessment levels by the respective sanggunian of cities and municipalities of Metro Manila is governed by rules and regulations issued by the Department of Finance.[99]

Special Levies

In addition to the real property tax, there are other levies on real property called special levies. They are the following:

Levy for Special Education Fund[101]

It is 1% of the assessed value of the real property which is paid in addition to the basic real property tax, and it shall exclusively accrue to the Special Education Fund.

Ad Valorem Tax on Idle Lands[102]

It is also paid in addition to the basic real property tax. This tax is imposed at a rate not exceeding 5 % of the assessed value of the property.

Special Levy[103]

It is imposed on all lands specially benefited by public works or improvements funded by the local government.

3. *Other Sources of Revenue*

a. Local governments are empowered to create indebtedness or enter into credit and financial transactions to finance local infrastructure and socioeconomic development projects, and to avail of credit lines to stabilize local finances.[104] Contracting loans, credits and other forms of indebtedness is authorized to finance "construction, installation, improvement, expansion, operation or maintenance of public facilities, infrastructure facilities, housing projects, acquisition of real property, and implementation of capital investment projects."[105] Procuring short, medium and long term loans and advances against security of acceptable assets is permitted for establishment, development or expansion of agricultural, industrial, commercial, house financing projects, livelihood projects and other economic enterprises.[106]

b. Other financial schemes like deferred-payment or supplier's credit arrangement is sanctioned to enable provinces, cities and municipalities (not available to barangays) to acquire property, plant, machinery, equipment and necessary accessories.[107]

c. Bonds, debentures, securities, collaterals, notes and other long-term securities may be issued by provinces, cities or municipalities (not barangays) "to finance self-liquidating, income producing development or livelihood projects" under an approved local development plan or public investment program, subject to Central Bank and Securities and Exchange Commission guidelines.[108]

d. Provinces, cities or municipalities (not barangays), in amounts not exceeding their surplus funds, may extend loans, grants or subsidies to other local government units (including barangays).[109]

e. The President, through government financial or lending institutions, may relend local government units (including barangays) proceeds of loans from foreign financial institutions or international funding agencies to finance construction, installation, improvement, expansion, operation, or maintenance of public utilities and facilities, infrastructure facilities, or housing projects, acquisition of real property, and implementation of capital investment projects.[110] Payment or amortization of the debt may be financed partly from income of projects and from regular local government income "which must be provided for and appropriated regularly in its annual budget until the loan and the interest thereon shall have been fully paid.

f. Local government units (including barangays) may enter into build-operate-and-transfer agreement with a duly prequalified individual contractor to finance, construct, operate and maintain financially viable infrastructure facilities subject to R.A. 6957.[111] Contractors are entitled to reasonable return of investments, to wit,

> *"repayment shall be made by authorizing the contractor to charge and collect reasonable tolls, fees, rentals, and charges for the use of the project facility not exceeding those proposed in the bid and incorporated in the contract: Provided, That the local government concerned shall, based on reasonableness and equity, approve the tolls, fees, rentals and charges: Provided, further, That the imposition and collection of tolls, fees, rentals and charges shall be for a fixed period as proposed in the bid and incorporated in the contract which shall in no case exceed fifty (50) years: Provided, finally, That during the life of the contract, the contractors shall undertake the necessary maintenance and repair of the facility in accordance with standards prescribed in the bidding documents and in the contract.*

XXXX

"In case of land reclamation or construction of industrial estates, the repayment plan may consist of the grant of a portion or percentage of the reclaimed land or the industrial estate constructed."[112]

IV. LOCAL FISCAL ADMINISTRATION

The law provides for cardinal rules or principles pertaining to local fiscal administration. They are mentioned in the Local Government Code, to wit:[113]

"(a) No money shall be paid out of the local treasury except in pursuance of an appropriations, ordinance or law;

(b) Local government funds and monies shall be spent solely for public purposes;

(c) Local revenue is generated only from sources expressly authorized by law or ordinance, and collection thereof shall at all times be acknowledged properly;

(d) All monies officially received by a local government officer in any capacity or on any occasion shall be accounted for as local funds, unless otherwise provided by law;

(e) Trust funds in the local treasury shall not be paid out of the treasury except in fulfillment of the purpose for which the trust was created or the funds received;

(f) Every officer of the local government unit whose duties permit or require the possession or custody of local funds shall be properly bonded, and such officer shall be accountable and responsible for said funds and for the safekeeping thereof in conformity with the provisions of law;

(g) Local governments shall formulate sound financial plans, and the local budgets shall be based on functions, activities, and projects, in terms of expected results;

(h) Local budget plans and goals shall, as far as practicable, be harmonized with national development plans, goals and strategies in goals and order to optimize the utilization of resources and to avoid duplication in the use of fiscal and physical resources;

(i) Local budgets shall operationalize approved local development plans;

(j) Local government units shall ensure that their respective budgets incorporate the requirements of their component units and provide for equitable allocation of resources among these component units;

(k) National planning shall be based on local planning to ensure that the needs and aspirations of the people as articulated by the local government units in their respective local development plans are considered in the formulation of budgets of national line agencies or offices;

(l) Fiscal responsibility shall be shared by all those exercising authority over the financial affairs, transactions, and operations of the local government units; and

(m) The local government unit shall endeavor to have a balanced budget in each fiscal year of operation.

A. *Supervising Authority*

Under the Administrative Code of 1987, the Department of Finance is responsible for the supervision of the revenue operations of all local government units, with the objective of making these less dependent on funding from the national government,[113-a] a thrust in concurrence with the government policy of strengthening local autonomy. One principal function of the Department is to ensure implementation of necessary policies and measures on local revenue administration.[113-b] Under the 1991 Local Government Code, the mayor and the governor exercise administrative supervision over their respective local government treasurers. Though appointees of the Secretary of Finance from among the recommendees of their respective local chief executives, local treasurers report regularly to the mayor or governor on local collection efforts.[113-c]

B. *Fiscal Officers*

Under existing legislation, qualifications and functions of local government fiscal officers are made uniform.

1. **Treasurer**[114]

The position of a treasurer is mandatory for provincial, city and municipal governments. He is appointed by the Secretary of Finance from among three or more recommendees of the local chief executive. He reports tax collection efforts to the local chief executive who exer-

cises administrative supervision over him. In addition to duties provided under Book II of the Local Government Code he:

a. advises the local chief executive, the sanggunian and other local government and national officials regarding disposition of local government funds and matters relative to public finance;

b. takes custody of, and exercise supervision over, local government funds;

c. takes charge in disbursing local government funds and funds entrusted to him by law or competent authority;

d. inspects private commercial and industrial establishments within the jurisdiction of the local government unit concerned in relation to the implementation of tax ordinances, pursuant to Book II of the LGC;

e. maintains and updates tax information system of the local government unit;

f. exercises administrative supervision, in case of the provincial treasurer, over all treasury offices of component cities and municipalities; and,

g. exercises other powers and performs other duties and functions prescribed by law or ordinance.

2. **Assistant Treasurer**[115]

The assistant treasurer assists the treasurer and performs duties assigned to him by the latter. He is authorized to administer oaths concerning notices and notifications to delinquent real property taxpayers and official matters relating to accounts of the treasurer or matters arising in the offices of the treasurer and the assessor. He is appointed by the Secretary of Finance from among three or more recommendees of the local chief executive. His position is optional for province, city, and municipality.

3. **Assessor**[116]

The appointment of an assessor is mandatory for provincial, city and municipal governments. In addition to duties set forth in Book II of the Local Government Code, he:

a. ensures proper execution of laws and policies governing appraisal and assessment of real property for tax purposes;

b. initiates, reviews, and recommends changes in policies and objectives, plans and programs, techniques, procedures and practices in valuation and assessment of real property for tax purposes;

c. establishes a systematic method of real property assessment;

d. installs and maintains a real property identification and accounting system;

e. prepares, installs and maintains a system of tax mapping, showing graphically all property subject to assessment and gathers data concerning the same;

f. conducts frequent physical surveys to verify and determine whether real property within the locality are properly listed in assessment rolls;

g. exercises functions of appraisal and assessment primarily for real property tax purposes in the local government unit;

h. prepares a schedule of fair market value for different classes of real property pursuant to Book II of the LGC;

i. issues certified copies of assessment records of real property and all other records relative to its assessment upon request of interested party and payment of a service charge or fee to the provincial treasurer;

k. submits a semestral report of assessments as well as cancellations and modifications of assessments to the local chief executive and the *sanggunian;*

l. attends, in case of assessor of component city or municipality, sessions of the local board of assessment appeals and presents information or record in his possession when required by the board;

m. exercises technical supervision and visitorial functions, in case of provincial assessor, over component city and municipal assessors, and coordinates with them in the conduct of tax mapping operations and other assessment activities providing all forms of assistance therefor. However, said functions are delegated to the city or municipal assessor when a component city or municipality provides in full the minimum personnel, equipment and funding requirements prescribed by the Secretary of Finance; and,

n. exercises other powers and performs other duties and functions prescribed by law or ordinance;

4. Assistant Assessor[117]

The assistant assessor assists the assessor and perform functions delegated to him by the latter. In addition, he is authorized to administer oaths on all declarations of real property assessment purposes only. His appointment is optional for province, city and municipality.

5. Accountant[118]

The position of accountant is mandatory for province, city and municipality. He takes charge of accounting and internal audit services of the local government unit. He also:

a. installs and maintains an internal audit system in the local government unit;

b. prepares and submits financial statements to the local chief executive and the *sanggunian;*

c. apprises the *sanggunian* and other local government officials on the financial condition and operations of the local government unit;

d. certifies the availability of budgetary allotment to which expenditures and obligations are charged;

e. reviews supporting documents before preparation of vouchers to determine completeness of requirements;

f. prepares statements of cash advances, liquidation, salaries, allowances, reimbursements and remittances pertaining to the local government unit;

g. prepares statements of journal vouchers and liquidation of the same and other adjustments related thereto;

h. posts individual disbursements on the subsidiary ledger and index cards;

i. maintains individual ledgers for officials and employees of the local government unit pertaining to payrolls and deductions;

j. records and posts in index cards details of purchased furniture, fixtures, and equipment, including disposal thereof, if any;

k. accounts for all issued requests for obligations and maintains and keeps all records and reports related thereto;

l. prepares journals and the analysis of obligations and maintains and keeps all records and reports related thereto; and,

m. exercises other powers and performs other duties and functions provided by law or ordinance.

6. **Budget Officer**[119]

The budget officer is a mandatory position for each province, city and municipality. Appropriations for personal services of the position is fully borne by the local government budget. In taking charge of the budget office, he:

a. prepares forms, orders and circulars embodying instructions on budgetary and appropriation matters for the signature of the local government executive;

b. reviews and consolidates budget proposals of different departments and offices of the local government unit;

c. assists the local government executive in budget preparation and in budget hearings;

d. studies and evaluates budgetary implications of proposed legislation and submits comments and recommendations thereon;

e. submits periodic budgetary reports to the Department of Budget and Management;

f. coordinates with the treasurer, accountant and planning and development coordinator for purposes of local government budgeting;

g. assists the *sanggunian* in reviewing approved budgets of component local government units;

h. coordinates with the planning and development coordinator in formulating local development plan; and

i. exercises other powers and performs other duties and functions prescribed by law or ordinance.

7. **Planning and Development Coordinator**[120]

The position of provincial planning and development coordinator is mandatory in each province, city and municipality. As the official responsible for the planning and development office, he:

a. formulates integrated economic, social, physical, and other development plans and policies for consideration of the local government development council;

b. conducts continuing studies, researches, and training programs necessary to evolve plans and programs for implementation;

c. integrates and coordinates all sectoral plans and studies undertaken by different functional groups or agencies;

d. monitors and evaluates implementation of different development programs, projects and activities in the local government unit in accordance with the approved development plan;

e. prepares comprehensive plans and other development planning documents for consideration of the local development council;

f. analyzes income and expenditure patterns, and formulates and recommends fiscal plans and policies for consideration of the finance committee of the local government unit pursuant to Title 5, Book II, of the LGC;

g. promotes people participation in development planning within the local government unit;

h. exercises supervision and control over the local development council secretariat; and

i. exercises other powers and performs other functions and duties prescribed by law or ordinance.

8. **Local Finance Committee**[121]

A must for every province, municipality and city, the local finance committee is composed of the local planning and development officer, local budget officer and treasurer. The committee:

a. determines projected income for the following year;

b. recommends revenue measures or borrowings;

c. recommends expenditure levels and spending ceilings to the local chief executive;

d. recommends proper allocation of expenditures between current operating expenditures and capital outlays;

e. recommends amount allocation for capital outlay;

f. assists *sanggunian* in review and evaluation of budgets of component local units;

g. assists *sanggunian* in analysis and review of own budget; and

h. conducts semi-annual review and examination of cost and accomplishments vs. performance standards.

V. BUDGETING AND FISCAL MANAGEMENT

The following is an overview of local government budgeting.

A. *Form and Content*

The local government budget is primarily composed of estimates of income and total appropriations covering current operating expenditures and capital outlays.[122]

The budget document contains three major elements:[123]

1. budget message of the local chief executive setting forth the significance of the budget in relation to the local development plan;

2. summary of functions, projects and activities to be accomplished; and

3. a set of financial statements indicating:

a. actual income and expenditures of preceding year;

b. actual income and expenditures of first two quarters and estimates of the last two quarters;

c. estimates of income for succeeding year;

d. estimated expenditures for succeeding year;

e. essential facts regarding the local government's obligations and indebtedness;

f. summary of statutory and contractual obligations; and

g. other data disclosing the financial condition of the local government unit.

B. *Local Budget Process*

a. Budget Preparation

Not later than July 15 of every year, local treasurers must submit to local chief executives detailed income and expenditure statements (3.1, 3.2 and 3.3 above) which shall be made the basis of the budget for the following year.[124]

July 15 is also the deadline set for department or office heads of the local government to submit respective budget proposals.[125] These proposals must be in accord, among others, with the policy and program guidelines issued by the local chief executive to conform with the local development plan, budgetary ceilings, and other requirements of law.[126] They must set forth (1) objectives, functions and projects, and their costs (2) organizational charts, staffing patterns indicating list of plantilla positions with corresponding salaries, (3) description of functions, projects and activities, and expected results therefor, (4) relation of work and financial proposal to local development plan, (5) estimated current operating expenditures and capital outlays compared with last two preceding, current and ensuing fiscal years, (6) accomplishment reports for the last two preceding and current fiscal years.[127]

After receipt of the income and expenditure statements from the treasurer, the budget proposals of department and offices heads, the income estimates and budgetary ceilings set by the local finance committee, the local chief executive prepares the local government budget which is then submitted to the sanggunian not later than October 16 of the same year.[128] The local chief executive may be held criminally and administratively liable in case of delay in the submission.[129]

b. Budget Legislation

The *sanggunian* shall enact the budget before the end of the current fiscal year,[130] otherwise, it is mandated to continue in session, without additional remuneration, solely for the passage of the budget until the same is enacted.[131] However, if, still, no budget is passed after 90 days from the beginning of the fiscal year, the budget of previous year is deemed automatically reenacted and shall be in effect until a new budget is enacted.[132]

c. Effectivity

The annual budget takes effect at the beginning of the following calendar year, while a supplemental budget takes effect only upon its approval or on a date fixed therein.[133]

d. Budget Execution

A primary responsibility in budget execution and accountability for it lodged with the local chief executive.[134]

e. Supplemental budget

The general rule is that all budget proposals must be covered by the annual budget. A supplemental budget is allowed only in the following cases:[135]

(1) when supported by funds actually available as certified by the treasurer or by new revenue sources; and,

(2)in cases of public calamity and by way of budgetary alignment, but only in areas which the President declared to be in state of calamity.

f. Reversions of Unexpended Balance

Unexpended appropriations in the annual budget reverts to unappropriated surplus of the general fund and are not available for expenditure except by subsequent enactment.[136] Capital outlay items, on the other hand, continue and remain valid until fully spent, reverted, or the project is completed.[137]

g. Continuing Appropriations[138]

Continuing appropriations are reviewed as part of the annual budget preparation and treated like new budget items. Funds which are no longer needed for continuing appropriations are reverted; no reversion takes place until obligations therefor are fully settled.

h. Budgetary Requirements[139]

(1) The total amount appropriated during the fiscal year should not exceed the estimates of income for the same period.

(2) All statutory and contractual obligations during the fiscal year should be fully provided for, but debt servicing should not exceed 20% of the regular income of the local government.

(3) Aids to each *barangay* by provinces, cities and municipalities should be at least P8,000.00.

(4) Five percent of the estimated regular revenue from local sources should be set aside as an annual lump sum appropriation to be spent for

unforeseen expenditures arising from occurrence of calamities only in areas to be declared by the President in a state of calamity.

i. Budget Limitations[140]

Use of these funds by municipal, city or provincial governments is subject to qualifications below.

(1) Appropriations for personal services during the fiscal year should not go beyond the following percentages of a local government's total annual income from regular income of the next preceding fiscal year: 45% for cities, municipalities and provinces belonging to 1st, 2nd and 3rd class, and 55% to other provinces.

(2) Salary rate of any employee or official should not exceed the maximum fixed by law.

(3) Unless a law provides, local funds should not be used to adjust salary of national government officials.

(4)Abolition and creation of career service positions should comply with the Local Government Code and the Civil Service law, rules and guidelines.

(5) Career positions in the official plantilla filled by incumbents holding permanent appointments should be covered by adequate appropriations.

(6) No changes in designation and title of position should alter the corresponding rank or compensation, unless the position is vacant and filling in is strictly made under Civil Service laws.

(7) Creation of positions or salary adjustments should not be made retroactive.

(8) Annual appropriations for discretionary purposes of local chief executives should not exceed 2 % of receipts actually derived from the basic real property tax in the next preceding calendar year.

j. Budget Review[141]

All budgets of the following local government units are reviewed by the Department of Budget and Management (DBM):

(1) provinces
(2) highly urbanized cities
(3) independent component cities
(4) Metro Manila municipalities.

The *sangguniang panlalawigan* reviews the budget of component cities and municipalities.[142] The *barangay* budget is reviewed by the *sangguniang bayan* or *sangguniang panlunsod*.[143]

The reviewing authority may declare the appropriations ordinance "inoperative", in whole or in part, if it fails to comply with any requirement specified in the Local Government Code.[144] In the process it shall give the proper advice to the *sanggunian* concerned. In case of the DBM and the *sangguniang panlalawigan,* they are given a 90-day review period, and they are deemed to have approved the budget subject of the review at the lapse of the period.[145]

k. *Barangay* Budget

The deadline for *barangay* treasurers to submit statements of income and expenditures to the *punong barangay* is September 15.[146] On the basis thereof, the *punong barangay* then prepares the budget in accordance with the same method prescribed for other local governments. The budget is then submitted to the *sangguniang barangay* for enactment.[147] The *barangay* budget is also subject to the same requirements and limitations imposed on other local government units with the further qualification that personal services for the barangay should not exceed 55% of the actual annual income of the next preceding year.[148]

Once enacted the *barangay* budget is then reviewed by the *sangguniang bayan* or *sangguniang panlunsod*. Both may authorize the municipal or city budget officer to do the review.[149] The review period is only 60 days within which the reviewing authority may declare the budget inoperative, in whole or in part, if it contains appropriations in excess of the estimates of the income certified as collectible, or in general, if any of the requirements set forth in the Local Government Code is not met.[150]

VI. ASSESSMENT OF LOCAL FISCAL PERFORMANCE: SOME ISSUES AND PROBLEMS (PRIOR TO THE LOCAL GOVERNMENT CODE OF 1991)

Developments in Philippine local government have been sweeping the area of fiscal administration.[151] The 1973 Constitution provided that each local government unit shall have the power to create its own sources of revenue and to levy taxes, subject to such limitations as may be provided by law (Article XI, Section 5). Implementing laws and decrees put into effect the Constitutional mandate.[152]

Presidential Decree No. 144 revised the system of national internal revenue allotments to remedy the lopsided distribution of funds among local government units. PD 231, as amended by PD 426, provided local govern-

ments with adequate sources of revenue to make them visible, self-sufficient, and effective instruments of national development.

In addition, Presidential Decree No. 464, which amended PD 76, improved real property tax administration. It provided for a general revision of assessment and classified real property for taxation purposes into residential, agricultural, commercial and industrial. PD 436 increased the specific tax on lubricating oils and other similar petroleum products, and granted provinces, cities and municipalities share in the specific tax thereon. PD 526 simplified supply management procedures. This decree on local fiscal management strengthened the supervisory powers of the then Ministry of Finance over local governments.[153]

The expected net effect of the Real Property Tax Code (PD 464) and PD 76 which upgraded assessment values should redound to at least 100 percent increase in the real property tax yield of most local units.[154]

Dr. Roy Bahl noted impediments to these developments. In his study of Philippine local finance, Dr. Bahl[155] observed that the country has not moved towards fiscal decentralization for the past decade. To support this view, Table 8-3 shows that the local governments expenditures is about 20% of the amount which the central government has spent in 1960. This dropped to 11% in 1974. The ratio of local expenditures from own sources to central expenditures decline from 19% in 1969 to 8% in 1990. It was observed that there was much centralization.[156]

As mentioned earlier, there were certain conditions and standards set by the central government that must be followed before the budget becomes legally operational. Under PD 477, the central government required that:[157]

1. the aggregate amount appropriated shall not exceed the estimated income certified collectible by the local treasurer;

2. the full provisions shall be made for all statutory and contractual obligations of the local government concerned;

3. twenty percent of the national internal revenue allotment accruing to the general fund of the local governments shall be appropriated for developmental projects or activities;

4. aids to legally constituted barrios shall be provided in amounts not exceeding P500.00 per barrio; and

5. two percent of the estimated revenue from regular sources shall be set up as a yearly unappropriated reserve to cover unforeseen

expenditures arising from the occurrence of natural calamities or financial dislocation on account thereof.

A. *Public Revenues*

As discussed in the earlier part of this chapter, the local government revenues have been increasing at a faster rate than LGUs share in the national government allotments. This means that the local government can be less dependent on the national government if proper incentives are given for them to generate their own sources of revenues. In terms of major classification of revenues, it is noted that the bulk of local government revenues are non-tax revenues.

There is a healthy sign of growth of revenues of local governments in current terms and constant value per capita revenue. The amount in constant value has increased from P695 million in 1960 to P324 million in 1990. The per capita revenue also has an upward trend increasing as high as 314 in 1990 compared to 11 in 1960. The average growth compared to national income is 2.42 percent.

By level of government, the public revenues of local government has an average growth of 15% compared to the national government's which is about 20%.

B. *Public Expenditures*

In terms of spending, there has been relatively little growth in per person expenditures by the local government in the Philippines. The reasons cited for this is centralization of government finances such that the national goal of promoting local economic development can hardly be achieved. Furthermore, there are more pressing national needs and this temporarily halted the progress in this area.[158]

The other views advanced are:

1. There are lack of incentives to local governments to increase their revenues.

2. There is the need of strengthening the fiscal management capability at the local government level and the central government level.[159]

The actual figures of expenditures of local governments from 1972 to 1978 are increasing. There is a noted large increase in 1975. The reason for this is that there was an increase of 15.2% in tax effort in that year, increase in internal revenue allotment, and increase in municipal license

collection.[160] The following are the analysis of the expenditures of the local government:

1. *Social Improvement* - It is observed that the expenditures for this purpose have not been active because the figures indicated that they only accounted for less than 15%. Combining both the expenditures for social and economic improvement will amount to only 31% which is less than 1/3 of the outlays of the local government. This confirms the finding of Dr. Bahl that because of the unitary form of government, the central government has failed to improve the socioeconomic lot of the people.

2. *Debt Service* - In terms of debt service or loan repayment expenditures, it can be figured out that local governments are not availing of credit facilities that could be made available to them. The reasons cited for these are: (1) The local governments, even with limited sources of revenue could still incur surpluses on the previous year's operations. The surpluses are meant to be accumulated to a satisfactory level so they could be sufficient to finance local development programs. (2) Credit facilities are highly restricted in reference to the integrity of loan repayments or the capability to service such. This is reflected in the low percentage of debt services.

Dr. Bahl said that in 1980 total amount of loans outstanding to the local government was equivalent to about 2% of the aggregate local government revenue. And the total amount of loans outstanding had been declining for the past 10 years. Dr. Bahl observed that this may be due to the following reasons:

a. Local government officials have no experience in the preparation of feasibility studies.

b. The lenders, because they are not specialized, have not developed the special skill of dealing with the problems of local governments.

c. The compliance procedures are difficult. The process of acquiring loans is very tedious, and time-consuming.

d. The terms for lending to local governments are very conservative. A market lasts for forty years but the maturity of the loans may only last for fourteen years.

e. The interest rates are high.

f. There are conservative local government officials who have the aversion to be in debt even if the money that may be borrowed may not be for their own. Former Metro Manila Action Officer Sarmiento[161] noted, however, that the lack of interest by the local officials to incur loan obligations

is due to the fact that there is lack of continuity of tenure by the local officials since they are only held in their post in accordance with the electoral process. This affects the projects already started by the past officials.

3. *Revenue Service* - The cost of generating revenue is quite high compared to the cost of generating revenue for the national government. In the BIR, the cost of collection is only 1% of the total collection[162] whereas the local governments as a whole incur an average cost of collection of 9% from 1972 to 1976. This could be attributed to some deficiencies in administrative capability in local government for the collection of revenues, e.g. the lack of coordination, lack of trained personnel and also lack of financial planning.[163] The reason of lack of financial planning is disputed however, by Ursal.[164] He says that it is not true that there is no fiscal planning because the planning is done with the top ministry particularly the Minister of Finance and the Minister of Local Government.

The other reason for the high cost of collection is the low payment returns of property taxes which should be a major source of revenue. The expenditure for personal service is invariably attuned to projected revenue collections. Since the actual collections fall short of the projections, the high overhead cost of collections in inevitable.

4. *Adjudication and Protective Service* - There is no significant change in the rate of expenditures for adjudication purposes. With regard to Protective Services, however, there is a noted decrease in 1975 which was due mainly to the integration of the National Police sometime in 1974-1975.

5. *Capital Outlays and Other Expenses* - Capital outlays significantly contribute to capital formation. Capital formation is the main problem of the Philippines and other developing countries. Thus, increasing efforts in capital outlays is in accordance with the government thrust in infrastructure projects that are expected to give long-term benefits. Despite the increasing share of local expenditures on all levels of government, local government outlays is in the direction of generating more revenues in the long run, hopefully an approach to better utilization of the local resources.

VII. PROSPECTS ON THE 1991 LOCAL GOVERNMENT CODE

Although many consider the 1991 Local Government Code a breakthrough in local autonomy, it is also viewed as having raised more questions than answers. One of the vital areas is local fiscal administration primarily because the actualization of local autonomy is heavily dependent on the fiscal independence and revenue raising capacity of the local government unit.

The following are the observations of Dr. Perla E. Legaspi:[165]

A. *On Taxing and Revenue-Raising Powers*

1. While tax rates were increased and the sharing schemes between and among different levels of local governments were readjusted, there actually was no new taxing power devolved. But the concern should not be on the grant of more taxing powers but on the very limited tax bases of rural areas, which makes ineffectual grant of more tax powers.

2. The fixing of tax rate ceilings clips the discretion of the local units.

3. Omission of some impositions previously prohibited may sanction taxes on banks and insurance companies, on insurance premiums paid by those who obtain property insurance directly with foreign companies, on mines and mining operations, and mineral products.

B. *On Real Property Taxation*

1. The increased share for barangays would encourage them to exert more tax collection effort.

2. The lifting of real property tax exemptions of government corporations may collide with the government policy of encouraging corporations to engage in exploration of alternative sources of energy.

C. *On Internal Revenue Allotment*

1. Contemporary settings indicate that the internal revenue allotment constitutes 60% of the local government income. Thus, the increase in the local government share to 40% of the national collections may make them more dependent on national allotments.

2. The change in the weights on factors which form the basis for the allocation of local government share may encourage local government units to improve their collection performance and is anticipated to benefit low-income local units.

3. While the increased share of barangays may spread development activities in their areas, the corresponding decrease in the shares of provinces and municipalities may be counterproductive since additional functions and responsibilities are shifted to these units.

4. The automatic release of the allotment may not be administratively feasible as the national government may be left without any effective tool for

imposing fiscal discipline, when, for instance, local governments refuse to pay their financial obligations or debts to the national government.

5. The 40% share may not cover expenses for the devolved functions. Initial estimates computed by the Bureau of Local Government Supervision (BLGS) of the Department of Interior and Local Government for Nasugbu, Batangas, show that the municipality would incur a deficiency of P3 Million. Increase in allotments also means decrease in other funds like Budgetary Aids, construction and maintenance of roads, and NALGU.

D. *Share in Proceeds from the Development and Utilization of the National Wealth*

While this is a welcome development, areas without or with scarce natural resources are disadvantaged.

E. *Local Budgeting*

1. The cumbersome problem of transferring money from one fund to another under P.D. 477 to respond to local developmental needs may find its answer with the maintenance of only one fund, the General Fund.

2. The prohibition against supplemental budgeting may adversely affect the ability of local governments to respond to emergencies.

3. The Code does not specify statutory obligations for which the local unit must allocate money.

F. *Financial Management Capability*

1. Studies indicate that local government taxing powers are not fully utilized either because of the lack of knowledge on the part of local chief executives or for political considerations.

2. The increased shares in revenues of barangays, especially those in rural areas, may not be productive in view of the limited technical knowledge of barangay officials in managing financial matters. Many may even be ignorant of fund sourcing or how to use development funds. Moreover, many barangays do not have safe cabinets wherein to keep collected revenues.

VII. CONCLUSIONS

On the basis of the problems and issues presented, it is worthwhile considering the following policy proposals to further strengthen local fiscal capabilities.

1. Fiscal planning should be the basis for preparation of the budget. Local governments have abused the methods of preparing supplemental budgets which renders the annual budget useless. Local governments should strive to develop effective financial plans so that the practice of preparing supplemental budgets can be minimized.[166] Further, the local executives should exhaust all avenues for generating revenues e.g. operation of enterprise, etc.[167]

2. Local government officials should be good fiscal managers. The effectiveness of local fiscal administration depends on the capabilities of local executives. Oftentimes, the local resources are not effectively utilized because of poor financial management. For instance, the mere passage of new LGC will definitely not ensure that local units will become tax power maximizers. With the increased shares in the proceeds of some taxes and the bigger share in the IRA, there is doubt on whether the LGUs, especially the barangays, will be able to manage efficiently and effectively their financial resources considering their limited technical knowledge. Local government executives need "to have a good grasp of the fiscal resources of their local units if they have to plan, organize and direct effectively the operations of their local governments."[168] In the same vein, the local government personnel should be equipped with technical skills.[169]

3. Local fiscal autonomy should be strengthened. It will be for the interest of the local governments if the restrictions in taxation and other revenue-raising powers of the local governments are liberalized. The Local Tax Code (PD 231) prescribes the taxes and other revenues that the local governments can levy and collect, yet there are so many statutory restrictions that paralyze the local governments.[170] V. Kane Salign[171] observes that although local authorities have powers to levy taxes, the decisions they can make concerning revenue are "nuts and bolts" decisions. "Lightening the existing 'nuts' and 'bolts' and supplying the missing ones may help avoid breakdown of the local financial structure. But to increase its capacity, there must be a transfusion of substantial additional resources."

The 1991 Code provides LGUs the resources needed to effectively discharge their augmented duties. LGUs will now receive a higher share in national taxes with more certainty, and have broader revenue raising powers. However, while the 1991 LGC gives LGUs more taxing powers, the Code is only an enabling act. In the end, local officials will have to decide what taxes they want to impose and at what rates.

4. Local governments should avail of credit financing schemes and other credit facilities. It has been observed that there are still LGUs which view credit as something that is to be avoided. Yet, it is a fact that local development programs necessitate a large volume of capital investment. Considering the various competing uses of financial resources, there may

be difficulties in obtaining funds for local projects. It is recommended that local government executives should avail of public and private loans. Generally, capital improvements which involve heavy organizational overhead should be funded from loans and other credit financing schemes so as to spread the burden of their costs.[172] The following are possible sources of local government credit:[173]

a. Loans from the National Government, the Philippine National Bank, and other banking institutions - for permanent public improvement purposes under Acts No. 2791 and 2956;

b. Loans from the Development Bank of the Philippines - for rehabilitation, construction or reconstructions of public markets, waterworks, toll bridges, slaughterhouses and other self-liquidating or income-producing services under R.A. 85;

c. Loans from DBP, PNB, and private entities for homesite purposes, provided interest on the loan does not exceed 8 percent, as provided under R.A. 264;

d. Loans from any private person or institution - reclamation purposes under R.A. 1899;

e. Loans from any private third parties - for any public works project under R.A. 2264, otherwise known as the Local Autonomy Act; and

f. Provisional loans from the Central Bank cash stabilization purposes up to 15 percent of average annual revenue of local governments, the application of which is restricted to cover budgetary deficits and expendable only for existing appropriations.

5. Local government units should share revenues and allotments from the National Government and increase their coordination capabilities. The practice of sharing revenues by the local governments should be pursued. The rich local government units can help other poor units in certain geographical or political subdivision in terms of the many services that the sharing system could provide. As noted by one Municipal Mayor of a fast-developing municipality,[174] there are poor and affluent local units but because of the sharing system, the rich ones are able to provide help to the poorer ones as in the case of the local governments' contribution to the Philippine National Police (formerly Integrated National Police). This is also true in the sharing of other mandatory obligations including the real estate and other national taxes. This scheme is felt to be acceptable to local government officials.

On the whole, since the local government units have been playing their role in the overall effort for national development, each unit should coordinate with other units so as to strengthen further their capability for more effective fiscal performance.

The provisions of the 1991 Code may render some of these propositions superfluous, however, this is only to stress the point that mere passage of the law without full implementation may just lead us back to square one.

END NOTES

[1]Gaudioso C. Sosmeña and Amanica G. Laureta, "Financing Local Development in the Philippines," *The Tax Monthly*, June 1976, Volume XVII, page 2.

[2]*Ibid.*

[3]*Ibid.*

[4]1 McQuillin, Mun. Corp., 3rd Ed., 456, cited in Ruperto G. Martin, *Public Corporations*, Revised (1983) ed., p. 5.

[5]*Ibid.*

[6]1 Dillon, Mun. Corp., 58, cited in Martin (1983), p. 5.

[7]1 McQuillin, Mun. Corp., 3rd Ed., 454, cited in Martin (1983), p. 6.

[8]Sosmeña, op. cit. p. 3.

[9]Sec. 1, Art X, Constitution, *1990 Fookien Times Philippines Yearbook*, p. 269 and *Fookien Times Philippines Yearbook 1987-88*, p. 13.

[10]Sec. 1, Art X, Constitution

[11]Sec. 198, B.P. 337.

[12]Sec. 462, Local Government Code of 1991

[13]Sec. 11, Art X, Constitution.

[14]Note however that Sec. 12, Art. X, of the Constitution prohibits voters of highly urbanized cities and component cities whose charters (laws creating them) from voting for provincial elective officials independent of the province.

[15]Sec. 459, LGC.

[16]Secs. 460 and 461, LGC.

[17]Sec. 467, LGC. One sectoral representative come from the women, one from the agricultural or industrial workers, and one represent other sectors (including urban poor, indigenous cultural communities, disabled persons).

[18]Sec. 463, LGC.

[19]Sec. 470, LGC.

[20]Sec. 448, LGC.

[21]*Ibid.*

[22]Sec. 250, LGC.

[23]Sec. 451, LGC.

[24]Sec. 452, LGC.

[25]*Ibid.*

[26]Sec. 12, Art. X, Constitution.

[27]Sec. 455, LGC.

[28]Sec 457, LGC. Sectors represented are the women, the workers (agricultural and industrial), and others (include urban poor, indigenous cultural communities, and disabled persons.

[29]Sec. 454, LGC.

[30]Sec. 470, LGC.

[31]Sec. 440, LGC.

[32]Secs. 441 and 442, LGC.

[33]Sec. 442, LGC. Under old Code, however, all municipal districts then existing are automatically converted into municipalities. Sec. 136, BP 337.

[34]Sec. 446, LGC. Sectors represented are women, workers (agricultural and industrial) and others (include urban poor, indigenous cultural communities, and disabled persons.

[35]Sec 443, LGC.

[36]Sec. 470 (a) and (b), LGC.

[37]Sec. 384, LGC.

[38]Under Sec. 385, LGC, if created through an ordinance of *sangguniang panlalawigan*, recommendation of *sangguniang bayan* concerned is necessary.

[39]Secs. 385 and 386, LGC. However, a population of at least 5,000 persons is required of *barangays* in cities and municipalities of Metro Manila, other metropolitan political subdivisions, and highly urbanized cities.

[40]Secs. 397 and 398, LGC.

[41]Sec. 390, LGC.

[42]Sec. 395, LGC.

[43]Art. X., Sec. 3, Constitution.

[44]Art. X, Sec.5, Constitution.

[45]*Ibid.*

[46]Sec. 4, Art. X, Constitution.

[47]Sec. 4, Art. X, Constitution and Sec. 25, LGC.

Martin (1983), p. 37, citing *Mondano v. Silvosa,* 51 OG 3427. There is a marked distinction between control and supervision. Supervision means overseeing or the power or authority of an officer to see that his subordinate officers perform their duties, and to take such action as prescribed by law if they should so fail to perform their duties. Control means the power of an officer to alter, modify, nullify or set aside what a subordinate had done in the performance of his duties and to substitute the judgment of the former for the latter.

[48]Sec. 25, LGC and Sec. 4 Art. X, Constitution.

[49]Sec. 25, LGC.

[50]Sec. 2, LGC.

[51]"Role of Local Authorities in National Development, Part II", Seminar on Local Government Administration and Development, March-April 1977, p. 5.

[52]Sec. 305 (k), LGC.

[53]Sec. 114, LGC.

[54]Sec. 305 (k), LGC.

[55]Sec. 305 (h), LGC.

[56]"Role of Local Authorities in National Development, Part II" Seminar on Local Government Administration and Development, March-April 1977, p. 9.

[57]Roy Bahl, *Strengthening the Fiscal Performance of Philippine Local Governments: Analysis and Recommendations*. Local Revenue Administration Project, The Maxwell School, Syracuse University, June 1981, pp. 8-9.

[58]Sec. 327, LGC.

[59]Sec. 326, LGC.

[60]Roy Bahl, *Strengthening the Fiscal Performance of Philippine Local Governments: Analysis and Recommendations.* Local Revenue Administration Project, The Maxwell School, Syracuse University, June 1981, p. 9.

[60a]Art. X, Sec. 14, Constitution.

[61]Sec. 308, LGC.

[62]Sec. 313, LGC.

[63]Secs. 272 & 309 (a) LGC.

[64]Sec. 309 (b), LGC.

[65]Sec. 6, Art X, Constitution.

[66]*Ibid.*

[67]Sec. 284, LGC. It provides for transitory percentage of 30 % on the first year of the effectivity of the Code; and 35 % on the second year.

[68]Sec 284, LGC.

[69]Last proviso, Sec 204, LGC. However, this cost is not included in the first year of the effectivity of the Code.

[70]Sec. 7, Art. X, Constitution.

[71]*Ibid.*

[72]Sec. 290, LGC.

[73]Sec. 291, LGC.

[74]Sec. 294, LGC.

[75]*Ibid.*

[76]Sec. 285, LGC.

[77]*Ibid.*

[78]*Ibid.*

[79]Sec. 290, LGC.

[80]Sec. 291 and 292, LGC.

[81]Sec. 135, LGC.

[82]Sec. 136, LGC.

[83]Sec. 137, LGC.

[84]Sec. 138, LGC.

[85]Sec. 139, LGC.

[86]Sec. 140, LGC.

[87]Sec. 141, LGC.

[88]Sec. 143, LGC.

[89]Sec. 147, LGC.

[90]Sec. 148, LGC.

[91]Sec. 149, LGC.

[92]Sec. 157, LGC.

[93]Sec. 151, LGC.

[94]Sec. 152, LGC.

[95]Secs. 153, 154 and 155, LGC.

[96]Sec. 186, LGC.

[97]Sec. 200, LGC.

[98]Sec. 215, LGC.

[99]Sec. 201 and 215, LGC.

[100]Sec. 218, LGC.

[101]Sec. 235, LGC.

[102]Sec. 236, LGC. Clearly, the government discourages non-use of lands especially when tillers are willing to die to have one.

[103]Sec. 240, LGC.

[104]Sec. 295(b), LGC.

[105]Sec. 297 (a), LGC.

[106]Sec. 297 (b), LGC.

[107]Sec. 298, LGC.

[108]Sec. 299, LGC.

[109]Sec. 300, LGC.

[110]Sec. 301 (a), LGC.

[111]Sec. 302, LGC.

[112]Sec. 302 (c) (4), LGC.

[113]Sec. 305 LGC.

[114]Sec. 470, LGC.

[115]Sec. 471, LGC.

[116]Sec. 472, LGC.

[117]Sec. 473, LGC.

[118]Sec. 474, LGC.

[119]Sec. 475, LGC.

[120]Sec. 476, LGC.

[121]Sec. 316, LGC.

[122]Sec. 314a, LGC.

[123]Sec. 314b LGC.

[124]Sec. 315 LGC. The LGC provides for a separate subsection on *barangay* budget which should apply in case of conflict.

[125]Sec. 317 LGC.

[126]*Ibid.*

[127]*Ibid.*

[128]Sec. 318, LGC.

[129]*Ibid.*

[130]Sec. 319, LGC.

[131]Sec. 323, LGC.

[132]*Ibid.* "However, only the annual appropriations for salaries and wages of existing positions, statutory and contractual obligations, and essential operating expenses authorized in the annual and supplemental budgets for the preceding year shall be deemed reenacted x x x x x"

[133]Sec. 320, LGC.

[134]*Ibid.*

[135]Sec. 321, LGC.

[136]Sec. 322, LGC.

[137]*Ibid.*

[138]*Ibid.*

[139]Sec. 324, LGC.

[140]Sec. 325, LGC.

[141]Sec. 326, LGC.

[142]Sec. 327, LGC.

[143]Sec. 333, LGC.

[144]Sec. 327, LGC.

[145]*Ibid.*

[146]Sec. 330, LGC.

[147]Sec. 331, LGC.

[148]*Ibid.*

[149]Sec. 333, LGC.

[150]*Ibid.*

[151]Roy Bahl, *Strengthening the Fiscal Performance of Philippine Local Governments: Analysis and Recommendations*, Local Revenue Administration Project, The Maxwell School, Syracuse University, June 1981, at note 20, p. 11-17.

[152]*Ibid.*

[153]*Ibid.*

[154]*Ibid.*

[155]Roy Bahl, *op. cit.* p. 11-5.

[156]Dean de Guzman and Arturo Pacho, *op. cit.* at note 46a p. 14.

[157]*Ibid.*

[158]*Ibid.*

[159]Dr. Bahl, *op. cit.*, Seminar on Strengthening Local Fiscal Performance, State Accounting and Auditing Center, Commission on Audit, October 1981.

[160]Commissioner Sarmiento, who was then an action officer for finance in the Metro Manila Commission.

[161]*BIR 1980 Annual Report,* Table 1, p. 6.

[162]Dr. Roy Bahl, *op. cit.*, at note 49.

[163]Manager Ursal is an expert on Local Finance and Taxation, corporate Audit Office, Commission on Audit.

[164]Bahl, *op. cit.*

[165]Legaspi, Perla E., "The Local Government Code of 1991: Issues and Problems," in *Local Government Bulletin,* Vol. XXVI, Nos. 3-4, July-December, 1991, pp. 4-5, 15-20.

[166]Bahl, *op. cit.*

[167]Sofronio Ursal, "Fiscal Resources in Relation to Local Management," *Local Government Bulletin,* January-June 1974, Volume IX, No. 1, p. 2.

[168]Perfecto Padilla, "Issues and Problems in Local Development," *Local Government Bulletin,* July-December 1975, Vol X, No. 2.

[169]See discussions by Bahl on this aspect. See also Raul P. de Guzman and Elena Panganiban, "Philippine Local Governments Under the New Constitution," *Local Government Bulletin*, July-December 1977, volume XII, No. 2, p. 4, LGC, p. 9. See also Raul P. de Guzman and Arturo G. Pacho, "Control Mechanisms in Central Local Government Relations," Seminar in Local Government, op. cit., at note p. 14.

[170]V. Kavesalingu, "Possible alternative and Additional Sources of Revenue for Local Authorities," ESCAP Report of the Seminar and Technical Papers Regional Seminar on Local Government Finance, Kuala Lumpur and Penang, Malaysia (5-17 august 1976), p. 3.

[171]Ursal, *op. cit.*, at note 55, p. 4.

[172]*Ibid.*

[173]Interview with Mayor Apolonio Reyes, Municipality of Tuguegarao, Cagayan, July 9, 1982.

[174]*Ibid.*

APPENDIX

SUMMARY OF LOCAL GOVERNMENT INCOME SOURCES

I. **National Government Assistance**

A. National Internal Revenue Allotment (IRA) apportioned among local government units;

B. Share in the exploitation of National Wealth located within their areas;

C. Share in the exploitation of National Wealth by a Government Agency or GOCC;

D. Other Revenue Sources such as those from the Philippine Chairty Sweepstakes, Horse Race and Lotteries.

II. **Local Assessments**

A. Local Government Taxes

a. The following taxes may be levied by provinces:

1. On transfer of ownership over real property;

2. On business of printing and publication;

3. Franchise;

4. On Sand Gravel and Other quarry Resources to be distributed as follows: Province 30%; City/Municipality 30%; Barangay 40%;

5. Annual Professional Tax;

6. Amusement Tax, to be divided equally by the province and municipality;

7. Annual fixed tax for delivery truck or van of manufacturers or producers, wholesalers, dealers or retailers of of distilled spirits, fermented liquors, soft drinks, cigars, cigarettes, and products determined by the *Sanguniang Panlalawigan;*

b. The following are levied by municipalities:

1. Tax on business on wholesalers, distributors, dealers, manufacturers, assemblers, repackers, processors, brewers, distillers, rectifiers, compounders, exporters, millers, contractors, banks, financial institutions, peddlers and others;

2. Fees and charges on business and occupation or practice of profession not reserved to the province;

3. Fees for sealing and licensing of weights and measures;

4. Fishery rentals, fees and charges;

5. Community tax paid by every resident at least 18 years old;

c. Cities levy all taxes, fees and charges that provinces and municipalities impose. However, those levied by highly urbanized cities and independent component cities accrue exclusively to them.

d. Barangays levy the following:

1. Taxes on stores and retailers with fixed business establishments with gross receipts no exceeding P50,000 in cities and P30,000 in municipalities;

2. Fees and charges for services rendered in connection with regulation or use of barangay-owned properties or service facilities like palay, copra or tobacco dryers;

3. Clearance fees on license permit issued by city or municipality for business or any activity;

4. Fees and charges on commercial breeding of fighting cocks, cockfights and cockpits;

5. Fees and charges on places of recreation which charge admission fees;

6. Fees and charges on billboards, signboards, neon signs, and outdoor advertisements.

e. Revenue raising powers available to all local government units:

1. Fees and charges for services rendered;

2. Charges for operation of public utilities owned, operated and maintained by them within their jurisdiction;

3. Toll fees and charges for use of public road, pier, wharf, waterway, bridge, ferry or telecommunications system funded and constructed by them;

4. Any tax, fee, or charge on any base not mentioned by laws provided that (1) it is not unjust, oppressive, excessive confiscatory, or contrary to national policy; and (2) public hearing shall be conducted.

B. *Real Property Taxes*

a. Real Property Tax Proper. Real property tax is imposed on every land, building, machinery and other real property located within the territorial jurisdiction of the local government unit collecting it. Under the law, however, only provinces and Metro Manila cities and municipalities are made "primarily responsible for responsible for proper, efficient and effective administration" of the tax. Respective sanggunians levy an annual *ad valorem* tax based on the assessed value of property. This is the reason why a system of assessment is an important step of real property taxation.

b. Special Levies

In addition to real property tax, there are other levies on real property, called special levies. They are the following:

1. Levy for Special Education Fund. It is 1 % on the assessed value of the real property which is paid in addition to the basic real property tax, which shall exclusively accrue to to the Special Education Fund;

2. *Ad Valorem* Tax on Idle Lands. Also paid in addition to the basic real property tax, this tax is imposed at a rate not exceeding 5 % of the assessed value of the property;

3. Special Levy. It is imposed on all lands specially benefited by public works or improvements funded by the local government

III. Other Sources of Revenue

A. Contracting loans, credits and forms of indebtedness to finance public works projects or procuring short, medium and long term loans and advances against security of acceptable assets for establishment, development or expansion of agricultural, industrial, commercial, house financing projects, livelihood projects and other economic enterprises;

B. Availment of deferred-payment, supplier's credit, and similar arrangements (not available to barangays) to acquire property, plant, machinery, equipment and necessary accessories;

C. Issuance of bonds, debentures, securities, collaterals, notes and other long-term securities (not available to barangays) "to finance self-liquidating, income producing development or livelihood projects"; corollarily, provinces, cities or municipalities (not barangays) may extend loans, grants or subsidies to other local government units (including barangays);

D. The President, through government financial or lending institutions, may relend to local government units (including barangays) proceeds of loans from foreign financial institutions or international funding agencies to finance public utilities and facilities, infrastructure facilities, or housing projects, acquisition of real property, and implementation of capital investment projects;

E. To enter into build-operate-and-transfer agreement to finance, construct, operate and maintain financially viable infrastructure facilities.

CHAPTER 9

PATTERNS OF PHILIPPINE EXPENDITURES, 1960-1990

I. INTRODUCTION

Development and Expenditures

II. THE DEVELOPMENTAL PROBLEMS OF DEVELOPING COUNTRIES

III. PHILIPPINE EXPENDITURE POLICIES

IV. CLASSIFICATION OF PHILIPPINE PUBLIC EXPENDITURES

V. PATTERNS OF GOVERNMENTAL EXPENDITURES

VI. EXPENDITURE PATTERNS ACCORDING TO NATURE OF EXPENSE

VII. THE EXPENDITURE PATTERNS OF THE NATIONAL GOVERNMENT

A. Economic Development/Service Expenditures

B. Social Development/Service Expenditure Patterns

C. General Government Expenditure Patterns

VIII. INTERNATIONAL COMPARISONS

IX. SUMMARY

PATTERNS OF PHILIPPINE EXPENDITURES, 1960-1990

I. INTRODUCTION

The expenditure system is the government's fiscal arm in producing, allocating and distributing social goods and services. Studies on the impact of government expenditures show a relatively strong influence on production, consumption, trade and prices, among others. That is, the expenditure activities of the government have certainly a potent influence on which track the economy should follow.

Properly managed public expenditures can contribute much to economic growth, e.g., through increasing income levels and generating additional employment. In developing countries, expenditure policies are designed and executed according to the development objectives and strategies. A well-formulated set of expenditure policies, firmly implemented, could serve as a solution to so-called developmental problems which throttle the development process.

As in the case of developing countries, the Philippines features a social structure of extreme class disparity and poverty. The majority of the people belong to the lower income strata, a large segment of which is below the poverty line. The elimination of poverty and the reduction of inequalities between these classes by a redistribution of income and wealth are therefore urgent considerations of its expenditure policies.

A major problem is the inadequacy of revenues due to low revenue performance and low tax capacity of the economy.[1] The inadequacy of revenues severely limits the ability of the government to finance its expenditure programs. Public sector deficit is growing fast and reliance on foreign borrowings is leading the country into a "debt trap."

The rising level of public expenditures in the Philippines is indicative of an increase in the size of the public sector. This reflects the growing role the government is playing in the economy. The growth of the expenditure levels from 1960 to 1990 could be considered dramatic in that its actual impact on the economy which it sought to promote is now the focus of attention. More interestingly, this expenditure growth, which was justified by the expanded functions of the government as a consequence of its development thrusts, has not been accompanied by a corresponding growth in revenues. The rapidly widening gap between available resources and expenditures has become alarming since it is difficult for the country to continuously rely on borrowing to finance its deficit. Debts will eventually have to be paid, the

principal plus the interests. As indicated by the magnitude of the country's debt and the portion of the budget that goes to debt servicing, debt may even stunt growth.

The patterns of expenditures before, during and after the Marcos regime in terms of their composition, i.e., sectoral or functional distribution; magnitude and effects are worth looking into. Thus, this paper attempts to review and analyze the patterns of expenditures from 1960 to 1990 in terms of the level and growth; the value of such growth in real terms; the composition of expenditures according to sectoral emphases; the reasons and conditions behind the patterns; and the implications of such trends and patterns.

This study employs actual expenditure measures because it is the only measure providing comparable data on total public spending, public spending by governmental levels, and by categories of functional areas.

Any discrepancy between and among the expenditure items and totals may be due to the differences in the sources of data and mode of data classification. What matters is that the trends in expenditure growth and patterns are captured.

II. THE DEVELOPMENTAL PROBLEMS OF DEVELOPING COUNTRIES

An expenditure policy could be understood better within the context of the development efforts and problems of a country.

It is believed that in the formulation of developing fiscal policies. Western economic percepts should not be readily copied or applied in Third World countries because of the differences in the economic, political and cultural characteristics between them and the Western countries. Because of such differences, a western fiscal policy as applied to industrialized countries may induce the desired economic effects, but if used by developing countries produces a different set of results, more often aggravating the problem it addresses. For one, the Western compensatory principle and pump-priming of the economy by developing country governments have not produced the desired economic effects on their economies.

Unlike developed countries, the Third World nations are confronted by numerous, interrelated problems which obstruct the development process. These problems have to be addressed by any expenditure policy of a developing country.

As in the case of the Philippines, most developing countries feature a social structure of extreme class disparities and extreme poverty. The majority of the people belong to the lower income strata, a large segment of

which is below the poverty line. The elimination of poverty and the reduction of inequalities between these classes by a redistribution of income and wealth are therefore urgent considerations of developing countries expenditure policies.

Capital accumulation, another developmental problem, is needed by developing countries to finance investment and development projects. But in these societies, per capital income is low and a greater part of it is used to cover basic necessities. Hence, the rate of savings is low. Worse, those who have the capacity to save utilize such savings in unproductive investments.

With low capital formation and investment, there are not enough economic activities to provide jobs for the growing labor force. Because of unemployment, the labor force is less productive. With the low level of productivity, the level of income is low. These interrelated problems which form a cycle require an expenditure policy for capital formation that takes into account the labor and income factors.

Another major problem of a developing country is the inadequacy of revenues due to low revenue performance and low tax capacity of the economy. The inadequacy of revenues in these countries severely limits the ability of each government to finance its expenditure programs. More often, it is forced to resort to foreign borrowings increasingly, thereby falling into a "debt trap."

III. PHILIPPINE EXPENDITURE POLICIES

Even in the sixties government objectives were already centered on three basic areas: stability, poverty alleviation and dynamic economic growth. The government was, however, careful not to indulge in excessive expenditures. The program for economic expansion then relied more on increased private investments. This partly explains the relatively higher budgets for social development especially from 1956 to late 60's. Nevertheless, priority was given to projects which aimed to attain self-sufficiency in food production and increased employment and income.

But in 1971, the Marcos government effected changes in budgetary allocations. The period 1971 to 1986 highlights the huge increases in expenditures for economic development. This, however, does not necessarily imply that before the Marcos years, economic development was less important but that during the Marcos government (as partly seen in how rapid the number of government owned and controlled corporations has grown during this period)[2] has assumed a more aggressive role in economic development. Top priority projects were on infrastructure and agriculture. Infrastructure, being the lifeblood of development got the highest budget

appropriation among various sectors. It included projects like construction and maintenance of feeder roads, bridges and power plants, which are considered vital to development. This was in line with the government's objectives of countryside development and redistribution of income and wealth.

The 1987-92 Medium Term Development Plan highlights the following fiscal objectives : "(a) to increase the flow of budgetary resources to activities supportive of employment generating rural-based activities and to social services; and (b) to improve the cost effectiveness of government operations." These then determine the distribution of government expenditures across sectors and across different economic categories under the Aquino administration. In the Aquino government, policy shifts changed resource allocation. From economic development expenditure flows were redirected to social development. The Agrarian Reform became the center piece program.

Needless to say, the country's development goals are taken into account in the expenditure policies which are aligned to the strategies of the development thrusts. Philippine expenditure policies throughout the various administrations could be summarized as pursuing the following basic strategies:

1. Redistribution of Income and Wealth and Balanced Development

One main policy of the Philippine government is income and wealth redistribution.

Because of the gross disparities in the level of socioeconomic-economic development in the country's various regional areas and among social classes, the expenditure system should make available governmental services to areas or sectors where public goods and services are insufficient or not available. The expenditure system is theoretically geared for the minimization if not eradication of poverty and the most effective and efficient distribution of basic social services.

2. Economic Development

Increased government spending is also a means of providing employment to the people. Jobs are created not only by those generated by government projects but also by those sectors providing goods and services to the government.

Allocation of funds would be given priority to economic services like expanded infrastructure program, investment and other outlays for capital formation.

The government would want to have a sustained cash outlay for infrastructure to serve as a counter-cyclical policy measure to cushion the effect of recession and keep the buoyancy of the economy. Infrastructure as a component of capital outlays is considered an imperative prerequisite for economic development.

For the accomplishment of self-sufficiency in food, it is the policy to further intensify the nationwide food production program to meet the needs of the growing population and to lessen the effects of inflation.

3. Stability

Like other developing countries, the Philippine economy is heavily affected by market externalities, specially the movements in the developed economies. In view of this, the expenditure policy must have preparedness and sufficient flexibility in reacting to sudden economic changes both in local and international scenes.

It is the Philippine government's policy to pursue expansionary measures as a means to combat the recessionary pressure spawned by worldwide economic events and to maintain whatever growth momentum is attained in previous periods. It also seeks to promote a desirable level and distribution of employment and income as well as of output and prices. The country's expenditure policy, together with the revenue policy and in context with the overall fiscal policy, is aimed at determining the favorable levels of financial operations to have a sound impact of these factors on the major economic aggregates, e.g. total demand, productivity, employment, balance of payments, the level of prices and distribution of benefits.

The maintenance and improvement of the domestic peace and order situation is also an important expenditure function for it is a prerequisite for the sustained growth and development of the economy and society.

4. Countryside Development

In terms of area development, high priority is given to projects that promote integrated regional development. This is to effect the dispersal of industries in the regions. Such will make viable the full utilization of labor and the resource potentials of the rural areas. It is also intended to resolve regional disparities. In addition, the resulting availability of employment opportunities in the countryside will help curb the problems of migration into urban centers.

IV. CLASSIFICATION OF PHILIPPINE PUBLIC EXPENDITURES

The Philippine public expenditures are classified in such a way as to permit the measurement of the costs and benefits of entire programs. National government expenditures are broadly classified into five (5) types which are:

1. Level of government

    a. National Government
    b. Local Government

2. Nature of expense

    a. Current operating expenditures

        i. Personal services
        ii. Maintenance and operating expenses

    b. Capital expenditures

3. Functional categories

    a. Economic Development/Services
    b. Social Development/Services
    c. National Defense
    d. General Government/Public Services
    e. Debt Service

4. Type of funds

    a. General fund
    b. Special Account - General Fund
    c. Bond Fund

5. Organizational Units, i. e., by departments and governmental agencies.

The items falling under current operating expenditures are "the purchases of goods and services in current consumption within the fiscal year, including the acquisition of furniture and equipment normally used in the conduct of government operations, and for temporary construction for promotional research and similar purposes." Stated in another way, these are expenditures which must be used for the continuing activities of the government.

The Commission on Audit (COA), as indicated in the Government Standard Chart of Accounts, has two (2) broad groups under current expenditures which are for (a) personal services and those for (b) maintenance and operating expenditures which include the cost of servicing debts.

Capital expenditures are outlays which are used for the purchase of goods and services, the benefits of which extend beyond the Fiscal Year and which add to the assets of government including investments in the capital of government-owned or controlled corporations and their subsidiaries.

The *functional* categories are broad groupings of expenditures covering the main functions of the national government.

The *general government/public services* category includes all general administration expenses (inclusive of allotments to local governments), administration of justice, pension and gratuities, contribution to international organizations, public order and safety, general research and other general public services.

Economic development/services covers the agriculture and natural resources, industry, trade and tourism, utilities and infrastructures.

The scope of social development/services expenses covers those of education, public health and medicare, housing and community amenities, social service and welfare, and other social service expenditures not classified elsewhere.

National defense/security includes all military expenditures but excluding those for the police forces.

Public debt or debt service expenditures are inclusive of redemption, interest payments, loan repayments and sinking fund.

As regards the classification of expenditures by nature of funds, the "(a) general fund is that which is available for any purpose to which the legislative body may choose to apply it, and is composed of the receipts or revenue which are not by law or by contractual agreement applicable to a specific purpose or purposes. The (b) special fund refers to the fund created for a special purpose or object and is used to defray specified expenditures or classes of expenditures. All money collected on any tax levied for a special purpose of object shall be treated as a special fund and paid out for such purposes only. The (c) bond fund refers to that fund arising from bonds floated by the government for specific purpose such as permanent public improvements."

V. PATTERNS OF GOVERNMENTAL EXPENDITURES

The expenditure pattern could be analyzed by levels of government, and in absolute and per capita terms.

A. *Growth*

1. Absolute Growth (at Current Prices)

In current prices, the growth of public expenditures was highest during the 1972 to 1980 period. This was because of the government's aggressive expenditure program in pursuit of national development during the Martial Law period (1972 to 1980). In a span of only 9 years, absolute public expenditures grew by over 559 percent whereas between 1960 to 1970, it only more than doubled its size with a 234 percent growth. Growth in 1980 to 1985 and 1985 to 1990 were not as high as in 1970 to 1980, although still relatively high as a consequence mostly of the growth in debt payments.

From 1960 to 1970, both the national government and local government units posted almost equal rates of growth at 239 percent and 212 percent respectively. However, between 1972 and 1980, most of the increases in public expenditures were attributable to the national government which registered an increase of 644 percent compared to the local government's 206 percent although the local government expenditures tripled by 1980 compared to the 1972 level. For the national government, the level grew by astoundingly eight times.

Per Capita Growth at Current Prices

In adjusting these figures for population growth, the per capita rate of growth of total public expenditures in current prices in the 1960-1970 period was reduced to 145 percent which is a little less than one half of the absolute growth for the same period. Thus, there was a fairly wide difference between the absolute and per capita growth. However, between 1972 and 1980, the per capita growth in current prices was still a high level of 433 percent or about three fourths (3/4) of the 559 percent absolute growth for the same period leaving a wider absolute-real growth gap. This means that in terms of the real level of growth in expenditures in current prices, the absolute level went up dramatically.

In current prices for 1960, the total expenditure was only 31 percent of the 1972 expenditure level while in 1970, it was 76 percent. However, by the end of 1980, absolute public expenditures were already 533 percent of the 1972 figures. This almost doubled in 1985 to 1,042 percent, and 5 years after, it more than doubled at 2,136 percent.

2. Real Growth (at Constant 1972 Prices)

Accounting for the effects of inflation, the current public expenditure figures were deflated by the Implicit Price Index of General Government Consumption Expenditures, with 1972 as base year.

The deflated figures show that from 1960 to 1970, total expenditures in constant prices grew by 281 percent, a little less than the current growth. In 1972 to 1980 period, aggregate real growth was 218 percent which is 340 percentage points less or about two fifths (2/5) of the growth in current prices for the same period. This indicates that the rate of inflation was quite high between 1972 and 1980, and like revenues, the expenditure growth may not necessarily be accompanied by real productive output. The inflation rates were even higher in 1985 and 1990 leaving the percentage of growth at 24 percent and 13 percent, respectively.

Per Capita Growth at Constant Prices

The effect of inflation is much more reflected by the growth of per capita expenditures. Real per capita expenditures grew by only 174 percent for the 1960-1970 period which is about three fifth of the aggregate real growth (at 281 percent) for the same period. The real per capita growth between 1972 to 1980 at 169 percent was less than its real absolute growth (at 218 percent) and less lower than the 1960-1970 growth. In 1985, growth went down to only 18 percent and further down in 1990 to just 11 percent.

3. Growth as to GNP

As percentage of GNP, total expenditures in absolute terms was almost constant at 11-13 percent in 1960 to 1972 while it progressively grew from 1971 to 1976, after which it has been bouncing up and down within the range of 16 and 23 percent, thereafter decreasing in 1980.

The gross national product (GNP) on the other hand, grew gradually. Growth before the 70's was very slow. Since 1972, it took only 3 years to double GNP and another 3 years to triple. In 1979, seven years from base year, the value almost quadrupled. In 1985, it was more than 10 times its 1972 level while in 1990, it reached to about 20 times!

The increase in the size of the public sector expenditures especially starting the Martial Law period can be attributed to two factors. The first and major factor was the aggressive effort of the administration to induce economic growth by increasing expenditures for economic development

especially for infrastructures. The second factor and perhaps the most pervasive factor was the series of price increases and the resulting recession as offshoots of the oil price hikes. Instabilities from the industrialized countries were brought in through borrowing which increased imports in the form of materials, technology and services, e.g. consultants. Faced with such problems, the government engaged in massive compensatory financing. It also sought to protect whatever momentum there was to keep the economy going. As discussed in Chapter 7, the revenues generated were not sufficient to meet expenditures. Thus, the government had to resort to borrowings. One unusual thing is that the share of national defense which was expected to increase during the Martial Law years didn't really rise significantly, although growth was very high in 1974-75 at 49 percent. In fact, it even declined in the initial years. This may be explained by the fact that the increases in other items were much higher such that although in absolute terms there were apparent increases in national'l defense, relative to the total, the increases turned out not as significant as others. In the late 70s, debt service started to become an important expenditure item from less than 10 percent of total expenditures in the 60's and early 70's to a high of 45 percent in 1987.

VI. EXPENDITURE PATTERNS ACCORDING TO NATURE OF EXPENSES

The expenditure patterns of the national government could also be analyzed by nature of expenses, i.e. current operating expenditures and capital outlays.

The amount expended in current operating expenditures is at all instances greater than that used for capital expenditures. At an amount of P991 million in 1960, current operating expenditures went up to P167,300 million by 1990, or an increase of P166,309 million which is equivalent to 16,782 percent growth for the span of 31 years.

On the other hand, capital expenditures moved up to from P205 million to P44,927 million for the same period. A growth of P44,719 million or over 21,814 percent was achieved.

Among the two main accounts of current operating expenditures, it is interesting to note that personal services accounted for the larger share of the expense from 1960 to 1972, after which its share somewhat decreased to the advantage of maintenance and other operating expenditures which showed expense levels up to twice that of personal services.

An item which registered a continuous increase in money value was that for debt service. This is indicative of the importance our government is placing on public borrowings to cover our budgetary deficits for developmental purposes. In another sense, it indicates the growing magnitude of public borrowings in our total expenditures.

The largest increase registered in money terms among the items under capital expenditures was those incurred for land, land improvements and structure outlays from P134 million in 1960 to P30,944 million in 1990 or an increase of P30,810 million.

The share of current operating expenditures fluctuated from a high level of 829 percent of national government expenditures in 1960 to a lower level of 79.0 percent in 1990, and peaked in 1966 at 89 percent. The decreases in the share of current operating expenditures resulted in a corresponding increase for capital expenditures. There is no distinct trend as to the allocation of expenditures inasmuch as all the percent shares in all items have been fluctuating, although one thing is definite: capital expenditures has always been far less than the allocation for current operating expenditures.

The increase in personal services was due to the increased scope of functions of the government which called for more manpower and a larger bureaucracy. Maintenance and other operating expenditures increased as a consequence of the expanded bureaucracy. However, its movement is not steadily upward. While its share of total public expenditures fluctuated from time to time only capital expenditures registered a continuously upward growth.

From 1960 to 1990, capital expenditures accounted for an average of 23.3 percent As an important indicator of capital formation, the amount expended as a percentage share of expenditures is very low. This is in consideration of the level of development of the Philippine economy. Noting the current policy statement on their importance, it is a fundamental requirement for economic growth. This is so because capital expenditures give impetus to higher productive capacity. Also, outlays on road networks and utilities.

As a policy for full employment, the government relied on a sustained cash outlay for infrastructures as counter cyclical measure against recession to stabilize the economy.

The patterns of distribution of expenditures according to nature of expense are not steady. The fluctuations, like that of functional categories of expenditures, could be due to the "exposed" economy's reactions to the erratic developments in the world economy.

VII. THE EXPENDITURE PATTERNS OF THE NATIONAL GOVERNMENT

Another way of analyzing expenditure growth is by inspecting its functional areas which reflect the main roles of the government. The trend of growth as was shown earlier was that the peso cost of government spending has increased in almost all areas. What is now determined is the change in these expenditures: where are shifts, if any, in the expenditures effected, and what is the significance of these shifts?

As to the money values expended by the national government by major functions, economic development comprised the bulk of government expenditures. It garnered much of the money outlays throughout the covered period, from P383 million in 1960 to P49,747 million in 1990 or an increase of P49,364 million. However, this category did decrease in peso value in 1977, as with the overall expenditures in the same year. The decrease, though, in expenditures in 1977 is attributed to revenue limitations and not regarded as a result of the policy of the government.

Of the five (5) major functional areas, only the expenditures for debt service steadily increased in peso terms from 1972 to 1980. The other functions exhibited fluctuations in trend. This steady increase in debt service is attributed to the heavy borrowing program of the government to finance budgetary deficits. Public domestic borrowings serve as a means of mobilizing savings which are supposedly to be devoted to development projects, whereas foreign borrowings are, as a policy, intended to finance the foreign exchange costs of the development projects and to cover the balance of payment deficits.

It could be inferred from the increasing debt service payments that the outstanding public debt balance had been accumulating in the period covered, hence, the government has been continuously resorting to foreign borrowings and would consequently pay an increasing debt service charge which did not show any sign of decrease between 1960 to 1990. Official Philippine development plans rely more on public borrowings which are planned to be reduced only by the latter part of the 80s.

Expenditures incurred for social development also increased from P415 million in 1960 to P56,144 in 1990. The increase registered was P55,729 million for the period. National expenditures had a relatively lower increase in value at P23,331 million between 1960 and 1990, whereas general government expenditures posted an increase of P22,114 million for the same period.

It is very clear that the priority area of the national government is the economic development outlays as shown by the consistently high share of expenditures which fluctuated between 15.6 percent to 49.1 percent during the early years up to the early Marcos administration but not during the Aquino years of total expenditures, i.e. an annual average share of 41.5 percent of the total. This is in line with the development plan to enhance growth. Before the period of Martial Law, the bulk of total expenditures went to social development/services. This was because of high priority placed on social development instead of economic development. Social services were considered more compelling and immediately needed even if in the proposed and appropriated expenditures, economic development was given equal emphasis.

The distribution of expenditures by functional areas is not really stable in terms of percentage share of each functions. There are wide fluctuations in the pattern. This erratic behavior of this distribution patterns could be an indication that the expenditure system is such that expenditures are made in response to external factors i.e., market developments in the world economy, which are beyond the control of government.

The functional category which rapidly increased especially until the 1990s has been debt service payments.

A. *Economic Development Expenditures*

Among the various categories of economic development/services, in 1960, the bulk of expenses went to transportation and communication expenses at P792 million while for agriculture and natural resources, the amount expended was only P540 million out of a total of P1,889 million for overall economic development/services. In 1973 and 1974, the agriculture and natural resources categories received a higher expenditure share. This was in line with the government's self-sufficiency drive in food production. The previous year, 1972, was characterized by heavy typhoons which resulted in poor harvest, hence, the need for the sector to recover made it imperative to increase its expenditure share. This was not withstanding the fact that the Philippines is still a predominantly agricultural country in the sense that more than half of its population depend on agriculture for livelihood. The efforts of the government paid off especially in the rice program in terms of increased production as the country did not only become self-sufficient but was able to generate some rice surplus which were exported to help earn badly needed foreign exchange.

For the rest of the period, transportation and communication/utilities and infrastructures received the bulk of the monies expended. This was in consonance with the thrust in capital formation outlays, especially with infrastructures. The share of this category rose from a low level of 12.8

percent of total expenditures in 1960 to a high point of 34.4 percent or more than a third of total expenses incurred in 1990.

In terms of index of growth, commerce and industry registered the highest growth between 1972 and 1978 at 1,004.3 index points. This was followed by agriculture and natural resources. However, if there were no changes made in the classification of data, it would be safe to infer that transportation and communication/utilities and infrastructures had the highest growth. This can be based on the amount of monies expended under these categories and on the thrusts of the first Five-Year development plan.

As pointed out earlier, it was not surprising that the expense for economic development/services covered the major portion of expenses from 30.6 percent of total expenditures in 1960 up to 46.4 percent in 1990. This is because of the importance given to the enhancement of productivity to generate employment opportunities, counter inflation, maintain social order, and improve the quality of life of the people.

B. *Social Development Expenditure Pattern*

Expenditures for social development benefit mostly the poorer segments of society. Education is the major category of this functional group. In the years 1960 to 1990, except for a few years (1979, 1982-85) the expenses for education was always more than half of the total amount that falls under this functional area. Only with an educated and skilled population can the country produce a productive and highly motivated manpower for development purposes.

Cognizant of this, the Philippine government expended 27 percent of the total national government expenditures in 1960 for this purpose. This remained about 1/4 of total national government expenditures until 1972. Since then it is "sad" to note that it only stayed near 10 percent and did not even got near 20 percent again except in 1973 at 18 percent. However, due to other pressing needs, the share of education dropped to 16.8 percent of the total expenditures in 1990.

In terms of growth, it is the category for labor and welfare which registered the highest index of growth at 3,254 index points by 1990, ahead of education with its lower growth of 2,533 index points and public health and medicare with only 3,058 index points.

C. *General Government Expenditure Patterns*

From 1960 to 1990, the general government expenditure category registered increases (except in a few years) from P130 million to P22,144 million or an increase of P22,014 million. Like all other items of expenditures,

the trends of the various categories under this functional area exhibited an erratic trend. Although among the items in this category, general administration comprised the bulk of expenditures. The same is true with regard to their percentage share to total expenditures. General administration got the biggest share among the various categories, reaching 6.7 percent of total national government expenses in 1960, its share went down to 5.7 percent in 1990. As of 1960, the general administration category had the highest index of growth at 21 index points. However, the 1990 growth trends exhibited the other general public services such as public order and safety with 3,574 index points against the 3,209 of general administration.

IX. INTERNATIONAL COMPARISONS

By Function

In the early 80s, the ASEAN countries were saddled with large fiscal deficits. Most of the countries were forced to adopt austerity measures. As a consequence, capital expenditures were adversely affected. The Philippines, Indonesia as well as Thailand reduced their capital expenditures by about 2/3 of their peak levels relative to gross domestic product (GDP).[3] Malaysia's capital expenditures suffered the most being cut to one fourth of the pre-austerity level (in GDP terms).[4] In contrast, current operating expenditures (COE) increased. For the Philippines, for instance, there was an apparent increase because the interest payments, which accounted for much of the rise, are part of the COE.

Among the selected countries studied, it is noticeable that all exhibited a decline in defense expenditures from 1972 to 1988. In 1972, aside from Bangladesh which has the lowest of only 5 percent of total allocated for defense, the Philippines has the lowest compared w/ the 5 other countries, with 15.7 percent. The same is true in 1988. In the World Development Report (1988), it was cited that some studies show that military spending is negatively related to economic growth. There may not be a strong evidence on this but it is a fact that where resources are scarce, the opportunity cost of expenditures on defense is high.

In education, the Philippine expenditures is not far from that of Thailand and Malaysia. While the Philippines and Malaysia exhibit an increasing pattern, Thailand shows otherwise. Singapore also allotted an increasing portion of their budget on education which reached to 6% of GDP in 1986.

For health, the US exhibits the highest expenditures followed by Singapore. The Philippines, Thailand and Malaysia, on the other hand , have

similar expenditure shares which are on average less than 5 percent of their respective total expenditures.

Of the social services, housing is another important expenditure item. Compare with other countries, the Philippines and Indonesia spent the least with 2 percent and 1.7 percent, respectively. US spends the most on housing among the countries.

For economic services, the selected developing countries show similar expenditure patterns and allocation which ranged from 17 to 33 percent. This may be an indication how big a role each respective government assumes when it comes to pump priming of each respective economies. In the case of developed economies, as represented by the US and Singapore, it is quite clear that not much is spent on economic development. This may be reflective of the limited role their governments assume and the bigger responsibility given to the private sector. The marked decrease in expenditures on economic services on transportation and communication in the 80s is only consistent with the downward trend in capital outlays.

X. SUMMARY AND CONCLUSION

Increasing public expenditures is primarily due to the expanded functions as dictated by the socioeconomic needs of the people, increasing urbanization, growing population and the resulting need for increases in existing services.

The shifts in sectoral priorities is evident in the historical data. These differences in the distribution of public spending reveals the priorities of the respective administration. Except for most of the Marcos years, priority has been given to social development. The Marcos administration had been more aggressive in pursuing economic development by appropriating relatively higher budgets for such purpose. On the other hand, in the Aquino government there was the dramatic rise in expenditures for social services. There was also the purportedly primacy of education spending in accordance with the 1986 constitution.

Fiscal policy objectives were manifested in the government's efforts to enhance economic activity through massive capital expenditures. However, it has been stressed in the study of Manasan (1990), that the ratio of current operating expenditures to total far exceeds that of capital to total. In

fact, compared to other Asian countries, the country's capital investments is still below average.

Over the years, defense expenditures relative to other budgetary items generally declined for the Philippines. The budgets on this were barely enough for maintenance much more for upgrading and modernization. In fact, the overall military hardware, according to a study, is far behind Southeast Asian standard. As one famous commentator said: "the Philippines is like a big museum, filled with antiques." He was of course referring to the World War II vintage navy ships and war planes. The decline of the ratio of defense expenditures to total expenditures could be attributed to the supposedly more economically productive spending. The fact is, the Philippines has the lowest military spending-to-GNP ratio in Southeast Asia. This is reflective of how high the opportunity cost of defense expenditures is for a relatively poor country like the Philippines.

As observed, the decline in economic services had its impact on infrastructure and basic utilities such as power, water services, roads and communication facilities. All these in favor of agrarian reform and natural resources. Now, the ill-advised sacrifice of basic infrastructure and utilities is becoming evident as more power and water shortages are experienced especially in the National Capital Region, which is the center of economic activity. Transportation and communication networks are lagging behind that of other ASEAN countries. This lack of infrastructure has become a major bottleneck in the Philippines as it is in Thailand, which is experiencing the same.

Meanwhile, the rise in social services primarily went mostly to education and health.[5]

A common observation is that despite the government effort to reduce the share of general overhead to the total budget through reduction measures such as streamlining of the bureaucracy, the number of employees even continued to grow. The perception is that the bureaucracy is still very much bloated.

As regards general public services, in real terms this sector grew from P297 million to P2241 million for the period 1960 to 1990 with the growth in public order and safety expenditures. Nevertheless, relative to the total it is almost constant. Note that this sector comprise the general operation of the government, the conduct of financial affairs including treasuryship functions,

the conduct of foreign affairs, the administration of justice and the maintenance of internal peace and order.[6]

The debt burden which comprises both principal and interest payments of domestic and foreign loans of the national government (including the advances made to government corporations (GOCCs) to service guaranteed debts)[7] has adversely affected budgetary allocation. The national government disbursements used for servicing debt ranged from 30 to 35 percent.[8] In addition, this is aggravated by the fact that a large portion of these payments were for projects which are now more of liabilities than assets or are already bankrupt or no longer existent, thus no longer contribute to the generation of foreign exchange for servicing. Although more than four-fifths of the foreign debt payments were for debts incurred before 1986, the present administration still cannot do without foreign debt.

Another issue on the debt servicing problem is that in the 80s, an increasing portion of the debt payments went to the domestic creditors. This means that the national government is actually incurring more domestic rather than foreign debts. The government had to resort to domestic borrowing since the mid 80s as a buffer to seasonal fluctuations in revenue collections and loan remittances that fund generally predictable levels of expenditures. In 1990 alone, domestic indebtedness of the government increased by almost four times as it was in 1985.[9] This brought about the rise in interest rates and the crowding out of available funds for private sector use.

ENDNOTES

[1]Manasan, R., "The 1989 Program of Government Expenditures in Perspective," PIDS Working Paper No. 88-26, 1988.

[2]See Briones and Sevilla, 1990.

[3]Manasan, R., "An Assessment of Fiscal Policy under the Aquino Government 1986-1988," PIDS Working Paper 90-06, 1990.

[4]*Ibid.*

[5]Bongcodin, E. , "Government Budgeting: Trends and Prospects", a paper presented during the National Conference on Public Administration, June 26, 1992 at Quezon City, p. 12.

[6]Bongcodin, 1992.

[7]Department of Budget and Management (DBM), 1991.

[8] Bongcodin, 1992.

[9]*Ibid.*

CHAPTER 10

THEORY OF THE BUDGET: APPLICATION TO DEVELOPING COUNTRIES

I. INTRODUCTION

II. BUDGETING PRINCIPLES AND THEORIES

III. MODERN DIMENSIONS OF BUDGETING FOR NATIONAL DEVELOPMENT

IV. TOWARD A PRACTICAL AND OPERATIONAL THEORY OF THE BUDGET FOR DEVELOPING COUNTRIES

V. CONCLUSION

THEORY OF THE BUDGET: APPLICATION TO DEVELOPING COUNTRIES

I. INTRODUCTION

The literature on budgeting is so numerous that the reader, student and the practitioner may end up more confused than enlightened. This situation points to the seeming lack of system, comprehensiveness and consistency in the classification used in budgeting, as well as lack of integration in budget documents. Despite the barrage of information and literature on the subject, little practical results are shown for the effort towards budgetary improvement, particularly in poor countries.[1] Corollary to this, the budget appears to be a most maligned, misunderstood and controversial subject with regard to national government policy. It has been called as "nothing but a mere scrap of paper, a voluminous farce, a huge piece of garbage," and has been criticized for being "greatly influenced by the negative emphasis which the press gives government spending."[2]

This chapter traces the theoretical foundations of budgeting from the traditional to the modern points of view, especially as they relate to the poor or countries. The range and complexity of governmental budgeting and the scope and variety of materials available on it accentuate the need for a brief, summary treatment of budgetary theory.

II. BUDGETING PRINCIPLES AND THEORIES

Budgeting is one of the universal human experiences. All of us face the problem of reconciling what we want with what we can afford. Even in the most primitive society, there must be a balance between the pasture available and the livestock that can graze on it. The problem of government is like that of individuals, only many time multiplied and much more complicated. Every government must face this problem of balancing needs and desires against resources and set up the institutional machineries for dealing with it. The experience is common to all governments, whether of developed or developing countries, but the circumstances are different for each one.

As the national budget evolved from its limited function or use to a more complex and broader one, one thing became discernible: the greatest difficulties for governments arise where resources are limited and needs and aspirations are sharply rising.[3]

The term "budget" may be traced back to the Middle English word *bowgette*, derived from Middle French word *bouget*, diminutive of *bouge* leather bag, which, in turn, was derived from the Latin *bulga*, meaning bag or purse.[4]

The *bouget* was used by the King's treasurer, the exchequer, to carry documents explaining the king's fiscal needs.[5] Later, the budget, containing the documents explaining the needs and resources of the country, was carried by the Chancellor or the Exchequer to Parliament .[6]

Understandably, the budget took on a much broader meaning as governments expanded their functions. Yoingco considers a definition of the budget arrived at by the American economist, Professor Philip E. Taylor, in 1961, as embracing almost all ideas of the term, ancient and modern:

> *"The budget is the master plan of government. It brings together estimates of anticipated revenues and proposed expenditures, implying the schedule of activities to be undertaken and the means of financing those activities. In the budget, fiscal policies are coordinated, and only in the budget can a more unified view of the financial direction which the government is going to be observed."*[7]

While Taylor looks at the budget as a master plan, Allan Schick views it as a process consisting of a series of activities relating expenditures to a set of goals.[8]

In a similar vein, Grooves and Bish consider budgeting as the process through which public expenditures are made. While considerations of revenue constraints and taxation are inherent in the budget process, budgeting is generally treated as a part of the expenditure process, rather than as a revenue-raising process. Therefore, a budget is necessary to provide a comprehensive view of revenues and expenditures to facilitate the process of rationing involved in raising and spending of public revenues.[9] In this respect, public budgeting serves as the allocation of expenditures among different purposes so as to achieve the greatest results.[10]

Quite interestingly, the budget or budgeting is viewed by Aaron Wildavsky at different levels, from its most literal sense to a recognition of its behavioral aspects.[11] In the most literal sense, Wildavsky says that the budget is a document containing words and figures which proposes expenditures for certain items and purposes. The words describe items of expenditures (salaries, equipment, travel) or purposes (preventing wars, improving mental health) and figures are attached to each item or purpose.

In the most general definition, budgeting is concerned with the translation of financial resources into human purposes. Thus, the budget may be viewed as a series of goals with price tags attached, hence a plan where choices are coordinated.

The budget also emerges as a network of communication in which information is continuously being generated and fed back to the participants. That an agency budget is an expectation, an aspiration, strategy and communication network, or as a precedent cannot be overemphasized.

The purposes of the budget are as varied as the purposes of men. One budget may be designed to coordinate and integrate diverse activities so that they complement one another in the achievement of common goals. Another budget may be formulated for a specific target clientele of a development program. Therefore, one may adopt a particular view of the budget depending on the purpose he has in mind. In this respect, Wildavsky emphasizes the importance of the political and behavioral aspects of budgeting. He considers the budgetary process as a phenomenon of human behavior in a government setting and treats politicians as dealers of "preferences" and of "what people want."

To sum up his view on the budget, Wildavsky writes, "Taken as a whole, the national budget is a representation in money terms of governmental activity. If politics is regarded in part as conflict over which preferences shall prevail in the determination of national policy, then the budget records the outcome of this struggle. If one looks at politics as a process by which the government mobilizes resources to meet pressing problems, then the budget is a focus of these efforts."

Given such a rundown on the meaning of the budget/budgeting and its scope, we can at this point arrive at a more encompassing and relevant definition applicable on a micro or macro level from an organizational to a national perspective. Eric Kohler defines the budget as a financial plan which serves as the pattern for and a control over future operations (hence any estimates of future costs) and as a systematic plan for the utilization of manpower material or other resources.[12] Implicit in Kohler's definition is the existence of a multiplicity of purposes for which budgets are constructed. More importantly, two major management functions are immediately discernible in the definition. First, a budget may serve as a plan indicating requirements of certain factors (e.g. cash, productive capacity) at some future date. Second, a budget may serve as a control, containing criteria of costs or performance which will be compared with actual data on operations, thus facilitating evaluations, and possibly encouraging or even enforcing some measures of efficiency.

Management and administration experts tell us that the purpose of a budget need not be limited either to the planning or the controlling function. It is not unusual for both to be represented in a single budget document.

III. MODERN DIMENSIONS OF BUDGETING FOR NATIONAL DEVELOPMENT

Budgeting involves a great range of interest and concerns as does government itself. A budget is a reflection of what the government is doing or intends to do. The national government budget is a translation in financial terms of the action program of government, coordinating planned expenditures with expected revenue collections and proposed borrowing operations,[13] hence a national plan that cuts across departmental boundaries and ties together all plans and projects. It is difficult to conceive of any public policy that can be carried out without money, and without being subject to budgetary processes at the development, review and implementation stages.

Besides its role in the political process and its impact on the national economy, budgeting has also been developed as an instrument of administrative control.[14] The chief task of government is that of framing the general economic financial and social policy which is expressed in the National Development Plan, the result of which should be the special activity of government embodied in the budget.[15] The budget therefore becomes the central financial apparatus. Most things that have fiscal implications are harnessed to it. It is the root of the multi-purpose orientation of budgeting, namely: control, management, and planning.

Budgets are variously referred to as financial plans, work plans or programs, or political and social documents. Improvements in budgeting are frequently made synonymous with such objectives as: 1) strengthening administrative processes, 2) achieving more effective or more stringent fiscal controls, 3) securing efficiency and economy, 4) effecting better utilization of resources, 5) controlling inflation or improving economic conditions 6) or simply broadening the awareness and understanding of budget control.[16] Thus, from the early and conventional treatment of the budget as basically a financial plan emphasizing mechanisms of expenditure control, the present day concept recognizes the economic implications of the budget and stresses it as an instrument of economic planning.[17]

A great number of developing or less-developed countries today give priority attention to budget-making. Budget preparation and formulation is an opportunity for governments to assess the volume of taxation and expenditures to offset threats of inflation or economic recession. There is a current wave of interest in the annual national government or agency budge as a work program with emphasis on relating costs to performance.

Another important dimension of budgeting for national development is its importance as a tool for learning the relationship of government programs with economic and financial conditions and trends, and for designing suitable economic and financial policies and measures. Because the budget embodies a national fiscal plan for taxing, borrowing, and spending a significant segment of the national income, it has a substantial impact on the country's fiscal soundness and national economy.[18]

The coordinative role of the national budget cannot be overemphasized. Budget preparation and execution are complex processes that involve wide participation throughout a government and these activities must be well-coordinated if the objectives and requirements of development are to be met. With wide participation, elements of control and discipline must be introduced if a unified national plan is to be formulated or carried out.

It must be emphasized that the national government budget and the Five-Year Development Plan or the Central Economic Plan of the country (1978-1982, 1983-1987) are both forecasts and contain elements of task-setting, target objectives, as well as elements of planning. Both also consist of some balanced sets of figures concerning money movements in a future period. Basic distinctions, however, exist. There are differences in arrangements and presentations and in binding force. The budget has the character of an authorization whereas the economic development plan has the nature of a guide and framework.

Therefore, the national budget cannot be considered the sole basis for the national coordination of policies affecting the economy as a whole unless it is made comprehensive enough to coordinate separate sources of accumulation which would include not only property under the scope of the "public sector" (e.g. local governments, financial institutions and government-owned- and/or-controlled corporations), but also those of industry, transport, agriculture, trade and cooperatives. Thus, the budget cannot be a substitute for an overall financial plan.[19] In this regard and taking into consideration that budget relates to public expenditure and policy analysis, the observation made by Robert Bangs, an American economist, is very appropriate and relevant. He writes: "Fiscal policy cannot be divorced practically from the total structure of economic policy, which in turn is merely a part of the larger cosmos of general policy within which any government administration operates."[20]

IV. TOWARD A PRACTICAL AND OPERATIONAL THEORY OF THE BUDGET FOR DEVELOPING COUNTRIES

The foregoing compendium of the budget's meaning, scope and role in naticnal development renders ironic the fact that there exists practically no theory on budget or budgeting. This situation was articulated by the Amer-

ican Professor of Political Science, V.O. Key, Jr., through a question: "On the expenditure side, on what basis shall it be decided to allocate X dollars to Activity A instead of allocating them to Activity B?"[21]

Inasmuch as budget administrators/managers or even planners could hardly provide an exact or profound answer to that basic question, Key inferred that there is a lack or no theory of the budget. Thus, for him, budgeting is a matter of philosophy as can be gleaned in the diverse interests of the present government as well as in the interests of the future ones.

Budget authorities likewise go beyond the question of how to judge estimates for particular functions or objectives. Their approach to agency estimates is directed towards efficiency with which a particular end is to be achieved. In this respect, few standards of evaluation are arrived at to determine the soundness of estimates. Therefore, more often than not, an impressionistic judgment on the object or thrust of the estimates is clearly evident.

Public finance experts were also noted by Key as having a lot to say on the expenditure side of the budget. However, they cannot articulate on the question of allocation of public revenues among different, at times competing, objects of expenditure. Corollary to this is the lack of attention by budget authorities to the development of a judicious method of ascertaining distribution of expenditures. Whatever methods or criteria arrived at should provide an answer to "what norm of expenditure is consistent with the state of progress achieved at present by the society."

Despite the proliferation of planners and planning/budgeting agencies in a developed country like the United States, a problem on the utility of public outlays is evident. According to Key, the problem concerns the development of criteria for selecting the object of public expenditures. As larger and larger portions of the national income is spent for public purposes, the sphere of the price system with its freedom of choice is more and more restricted. Public officials need to develop methods of selecting and prioritizing objectives of expenditure which will bring the greatest utility of return and most accurately achieve the social aspirations of the people. Thus, if planning is to be "overall", it must devise techniques for balancing values within a framework that gives due regard to the diverse interests of the present and the future.

There is, however, some doubt or apprehension on ascertaining in precise or exact terms the relative "values" of public services. In the first place, such a task might prove fruitless because of the influence of pressure groups in the determination of the allocation of funds. Each spending agency has its clientele and will justify that such clientele deserves only the best attention and services which can materialize only through the necessary

allocation. In effect, the allocation of the government's limited resources vis-a-vis different demands seeks the maximization of return in the interplay of various forces. The allocation presumably reflects the social consensus on the relative values of different services. If this is true, the more efficient utilization of resources should be promoted by developing the means of measuring more accurately the political strength of interests competing for appropriations.

Each year the national government budget, before its authorization or final legislation, is presented in the form of an Appropriation Bill. In the United States, as well as in a developing country like the Philippines, the Appropriations Bill expresses a social consensus which sounds akin to the mystic doctrine of the "general will." Constantly, in the process of formulating the Appropriations Bill, choices have to be made between the demands of the different groups and factors, aside from making the estimates of the relative political strength of contending groups that frequently enter into the decision.

Finally, when the bill is enacted into a law (or the General Appropriations Act) one is wont to ask: Does the Act embody the general will in the light of the authorized appropriations for each sector, objective of expenditure? Is there a rational allocation of resources? What was the basis for allocating billions to the energy program instead of allocating the same amount to social development or to a housing program?

In cognizance of the difficulty of providing sound, objective answers to these questions, Key called for a reexamination of the budgetary process from the viewpoints of economic theory and political philosophy. This necessity is bolstered by the fact that the utilization of public funds is a matter of value preferences and judgments.

Although written in 1940, the significance and implications of Key's article and the challenge it posed cannot be overemphasized. For one, it denotes a very weak system of determining priorities of government, particularly in developing countries. In other words, while the literature on public finance for both developed and developing countries is replete with references to the budget, the function of relating it to the expenditure side is hardly systematized. Neither is there a clear-cut presentation of the manner by which the ever limited resources of government are equitably or judiciously allocated. This hinges on the existence of standards or criteria by which to determine the priorities of government in so far as its development programs/projects are concerned. Specifically, a number of questions may be asked in this respect, most significant of which are:

1. Who finally sets and decides on priorities?

3. To what extent and how do citizens participate in this area?

4. What techniques/tools are employed in the process or prioritization or selection? (e.g. feasibility study, cost/benefit Analysis, Cost/Effectiveness, etc.)

5. How is the social desirability/utility of the approved program/projects measured?

6. What happens if programs/projects which were deprioritized originally, turn out, by popular demand, to be programs which are really needed by the people? Will there be a reallocation of resources during the execution phase of an approved national government budget?

There is no doubt that answers to these questions will prove to be highly prescriptive in nature.

Evidently, there has always been a big gap between normative prescriptions vis-a-vis actual situations or operationalization of theories. It behooves, therefore, every administrator to blend or have a balanced combination of the theory and practice of public budgeting.

Nevertheless, the attempt to systematize a theory of the budget on the expenditure side is an encouraging sign. At least one has thought of responding to the challenge of V.O. Key, Jr. even if the response came only in 1952, twelve years after the publication of Key's article. Verne Lewis, an American economist, expounded on the possibility of arriving at an economic theory of the budget through the application of the basic economic phenomenon: the marginal utility theory which was first formulated by Pigou.[22]

Lewis contended that budget authorities could arrive at an economic theory of budgeting following these principles:

1. Since resources are scarce in relation to demands, the basic economic test which must be applied is that the return from every expenditure must be worth its cost in terms of sacrificed alternatives. Budget analysis, therefore, should be basically a comparison of the relative merits of alternative uses of funds.

2. Incremental analysis (i.e. analysis of the additional values to be derived from an additional expenditure) is necessary because of the phenomenon of diminishing utility. Analysis of the increments is necessary and useful only at or near the margin; this is the point

of balance at which an additional expenditure of any purpose would yield the same return.

3. Comparison of relative merits can be made only in terms of relative effectiveness in achieving a common objective.

An elaboration or illustration of each of the principles is discussed as follows:

Principle No. 1

Inherent in this principle are the concepts "relative value," "sacrificed alternatives" and "opportunity costs." As has been underscored, budget decisions are made on the basis of relative values. But there is no absolute standard of value. Values are difficult to determine. They keep changing and a change in values depends on time and the environment wherein decisions are made.

Scarcity of resources in relation to demands confronts us at every level of public budgeting. Confronted with limited resources, decision makers must make choices. On what basis should the choice be made? The general answer to this is found in the doctrine of marginal utility as laid down by Prof. Pigou.

Under the concept of marginal utility, the problem of making choices is tackled in terms of relative values rather than absolute values. The principle of balance embodied in the concept further postulates that the resources should be so distributed among different uses that the marginal return of satisfaction is the same to all of them. As far as the theory goes, we have a test by means of which the distribution of expenditures among different purposes can be settled.

Of what significance from the point of view of budget analysis are the concepts of relative values and displacement/opportunity cost? The answer to this is based on this logic: The returns from an expenditure for any activity must be more desirable and more necessary than for any alternative use of funds. From deciding on two alternatives, one incurs an opportunity cost which refers to the cost of a thing/service which must be given up for the other alternative taken. In the process, therefore, budget analysis should indicate that results must be worth that cost (based on the doctrine of marginal utility) in terms of alternative results that are foregone or displaced. To illustrate this point, government decision-makers should be able to justify that the results/benefits to ensue from a nuclear power plant program are worth the supposed benefits of the sacrificed or canceled reforestation program.

Principle No. 2

The principle of incremental analysis means that as we acquire more and more units of anything, the additional units have less and less value. This will ultimately result to decreasing benefit per additional amount or cost. For instance, a car owner would definitely value so much a fifth tire as his reserve to the four functioning tires. If he buys a sixth tire or seventh tire, their value would be much lesser than the fifth as they are intended for the same purpose.

In the comparison of values, the marginal utility theory suggests that maximum returns can be obtained only if expenditures are distributed among different purposes in such a way that every dollar (or peso in the case of the Philippines) spent for each yields the same real return.

Principle No. 3

The most common method of determining the relative effectiveness of things vis-a-vis their professed relative merits is through Cost-Benefit Analysis.

Analysis and evaluation of relative effectiveness in achieving a common objective requires a set of basic premises which are found in the ultimate ends or purposes established by the legislative body (or the Congress in the case of the Philippines) "acting for and in behalf of the people." Presumably, this structure constitutes what makes "the best use of resources."

As a reaction to Verne Lewis' proposed economic theory of the budget, V.O. Key, Jr. emphasized a basic limitation of the marginal utility theory to public budgeting. He stressed that the doctrines of marginal utility, developed mostly in the analysis of the market economy, has a ring of unreality when applied to public expenditures.[23] The most advantageous utilization of public funds resolve itself into a matter of value preferences between ends lacking a common denominator. As such, the question is a problem of political philosophy.

Realizing the validity of Key's position, Lewis ultimately conceded to the constraints posed by his proposed economic theory of the budget. This was sharply focused on the following observation of Lewis: "In real life, budget decisions are undoubtedly influenced to a greater or lesser extent by such non- economic and non-rational factors as pride and prejudice, provincialism and politics."[24]

In another context, an attempt towards a fiscal theory of the budget was postulated by Dr. Jose Soberano.[25] He noted that the prevailing theories of the budget applied in developing countries are based on "economies of

abundance." When these are applied to "economies of poverty," things get out of control. In the case of the Philippines, while our technical expertise is on par with those of industrialized countries, a single flood, a prolonged drought, an earthquake or internal security problems can throw the most well-planned budget out of gear and set carefully formulated priorities into disarray. To him, the problem is not so much a question of theory and technique, since the Philippines is up-to-date on these, but the very problem of poverty itself. In conditions of underdevelopment, many variables cannot be programmed and controlled, including nature.

Soberano postulated a budget theory focusing on the fiscal (or public finance/administration) side may be possible if certain requirements are met, namely:

1. *A Positive Government* - This is committed to actively formulate programs in fulfillment of societal balance necessary for the good life. It is a government that is established and sustained according to its performance in preserving the public interest (underscoring supplied) and dedication to the cause of public service.

2. *Scientific Policies* - This is able to ascertain in popularly understood terms the requisites for the good life, the delimitations of the public interest, and the nature of the societal balances for which it is organized. These are policies which have operations and processes open to precise verification and validation in every significant aspect of performance, and whose ranks and positions are accessible and are open for popular, knowledgeable competition.

3. *An Abundant Economy* - This assures everybody the optional level of welfare consistent with resources availability, technological progress, population policy, and ultimate human creativity. No artificial scarcities are imposed on account of doctrine other than the logical necessities governing production and civilized social living.

4. *A Responsive Society* - This is directed towards the propagation of the common good, keen awareness of rights and entitlements amidst the possibilities of organized life. It is responsible for its performance according to the rules of civility and is knowledgeably prepared to reciprocate benefits received with services rendered.

To a large extent, the propositions of both Verne Lewis and Jose Soberano are anchored towards a normative theory of the budget. They are indubitably meaningful prescriptions, in so far as government budgeting is concerned. The feasibility of applying such budgetary norms and requisites poses problems. But budget authorities and decision-makers may as well

take into consideration the proposed budgeting theory, whether economic or fiscal, as some guideline or framework which will immensely aid in determining objectives, rational and socially-inclined decisions concerning prioritization and allocation of resources. At the same time, there is a built-in recognition that if all prescriptions or norms are what they actually are in our government budgetary setting, then we are living in a utopian world.

The discrepancies between what government budgeting purports or professes to be (normative) *vis-a-vis* what it actually is (descriptive) are spurred by factors which range from divergent interests, the prevailing political climate, to the gap between planning and budgeting. Equipped with the proposed "theories" and a framework of budget analysis, it is possible that such disparities or conflicts can be obviated by budget authorities/decision-makers. The path towards rationality in budget making in the name of the general will may be facilitated through the commonality of perspective/terms or orientation of the decision-makers (those who set the priorities and therefore decide on the allocation) on one end, and a closer linkage among the budget and planning agencies on the other.

On top of everything is a recognition by the national/ political leadership that the allocation of the limited resources of government, which is translated yearly through a General Appropriations Act, is one that is based on *need,* not *want.* And such need is one that is actually felt and articulated by the target beneficiaries of the programs/projects. Likewise, the decision-makers have to accept the fact that not everything that applies or is made feasible in one country, is expected to similarly work in another country. On the other hand, what may have been ineffective in a developed country's system may prove to be effective and useful to a developing country.

V. CONCLUSION

To summarize, a review of theoretical writings on the budget reveals that it can be viewed from three frames of reference: the budget as an economic process, as a political process, and finally as an administrative process. Economists who have formulated theories on the budget look at it as a process of resource allocation. They have suggested various approaches to help decision-making on resource allocation. For example, Verne Lewis' emphasis on the marginal utility theory and sophisticated decision-making techniques like cost-benefit analysis, feasibility studies, etc., help the policymaker decide among competing budgetary options.

On the other hand, Pendleton Herring, Wildavsky and other political scientists view budgeting as essentially a political process of competition among various groups for limited resources. Therefore, those who have access to political power get a bigger share of the budget pie.

Those who look at budgeting as an administrative process think in terms of mechanisms for planning, coordination, control and evaluation. Thus they talk about line-item budgets and performance budgets. We have various theories which explain different aspects of budgeting. These theories, coming as they are from different disciplines, have different ways of looking at the same problem, measuring it and proposing solutions. Even the language is different. The problem comes from the very nature of budgeting, which, like all other activities in fiscal administration, have economic, political, and administrative aspects.

When these theories are transported to developing countries, budgeting becomes even more complicated and unmanageable. Soberano has pointed out twenty years ago, that the problem of budgeting in developing countries are rooted in the problems of underdevelopment. As more and more sophisticated budgetary techniques and approaches are developed and adopted from industrialized countries, perhaps we should bear in mind that they can only be successful and effective in the context of efforts at understanding and attacking the basic problems of underdevelopment.

ENDNOTES

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[16]*Modernizing Government Budget Administration*, p. 8.

[17]*Ibid.*, p. 8.

[18]*Ibid.*, p. 9.

[19]Felisa D. Fernandez, *op. cit.*, p. 9.

[20]Robert Bangs, "Financing Economic Development," *Fiscal Policy for Emerging Countries* (Chicago and London: The University of Chicago Press, 1968), p. 57.

[21]V.O. Key, Jr., *op. cit.*, p. 474.

[22]Verne B. Lewis, "towards a Theory of Budgeting," from *Public Administration Review*, Vol. 12, Winter, 1952, pp. 42-54 and reprinted in Philippine Public Fiscal Administration, p. 481.

[23]*Ibid.*, p. 488.

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[25]Jose D, Soberano, "Towards a Fiscal Theory of the Budget," *Seminar on Budgeting for National Objectives*, College of Public Administration, University of the Philippines, Manila, 1974.

CHAPTER 11

APPROACHES AND TECHNIQUES IN BUDGETING: THE PHILIPPINE EXPERIENCE

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APPROACHES AND TECHNIQUES IN BUDGETING: THE PHILIPPINE EXPERIENCE

I. INTRODUCTION

Numerous terms and abbreviations have been coined in budgeting - LIB (Line-Item Budgeting), PB (Performance Budgeting), PPBS (Planning, Programming, Budgeting System) and ZBB (Zero-Base Budgeting System).

Budgeting approaches and techniques in many developing countries, the Philippines in particular, are largely American- introduced, American-installed, and for a while American- supervised. It is difficult to think of local budgeting practices which cannot be traced to American concepts, techniques, approaches, and even advice. In the Philippine experience today, American influence in local fiscal administration is most apparent in the area of budgeting.

The Americans themselves set-up the administrative system in the Philippines when the latter was still a colony of the United States. This system was largely unchanged even after the granting of the so-called "independence" and our transition from the various regimes to the present Republic.

This chapter will present a brief review and analysis of the four basic methods and approaches in budgeting. Focus will be on main features, limitations, and constraints in implementation of each approach. Before discussing the approaches, a resume' of the general orientations in budgeting is necessary, since each approach is dominated by a distinct orientation.

II. ORIENTATION IN BUDGETING

The stages in the evolution of the United States' federal government budget are characterized, according to Allen Schick,[1] by three major orientations: control, management and planning.

A. **Control Orientation** in budgeting is the process of enforcing limitations and conditions set in the budget and in appropriations, and of securing compliance with spending restrictions imposed by central authorities. If the budget details the allowances for items of expense, central budgeters will be required or at least motivated to monitor agency actions in order to enforce the limits.

A line-item budget has a control-orientation in view of its limited concern and its focus on expenditure classifications or detailed tabulations of the

items required to operate an administrative unit - personnel, fuel, rent, office supplies and other inputs. On these "line-itemizations" are built technical routines for the compilation and review of estimates and the disbursement of funds.

A control-oriented budget process subordinates management and planning but does not eliminate them altogether. The crucial issue is the balance among these vital functions. With emphasis on control to keep expenditures within stipulated levels and ceilings, these narrow range of concerns are considered: (a) How can agencies be held to the expenditure ceiling established by the legislature and the chief executive?; (b) What reporting procedures should be used to enforce propriety in expenditures?; and (c) What limits should be placed on agency spending for personnel and equipment?

B. **Management Orientation** involves the use of budgetary authority at both agency and central levels to ensure the efficient use of staff and other resources in the conduct of authorized activities. In management-oriented budgeting, the focus is on agency outputs - what is being done and produced and at what cost and how does performance compare with the budgeted goal? This orientation is best illustrated in a performance budget. It is more concerned with operations and results rather than control, with efficiency rather than the legality of expenditures.

The shift from control to management orientation necessitates concern over these fundamental issues: (a) What is the best way to organize for the accomplishment of a prescribed task?; (b) Of the various grants and projects proposed, which should be approved?; and (c) What is the maximum productivity derived from a unit of input? This new orientation focuses attention on the problems of managing large programs and organizations, and on the opportunities for using the budget to extend executive hegemony over the dispersed administrative structure.

C. **Planning Orientation** refers to the process of determining public objectives and the evaluation of alternative programs. To use the budget for planning, central authorities must have information concerning the purposes and effectiveness of programs. They must also be informed of multi-year spending plans and of the linkage between planning, spending, and public benefits.

According to Schick, three important developments influenced the evolution from a management to a planning orientation in the sixties:[2]

1. Economic analysis - the emergence of macro and micro analysis has had an increasing part in the shaping of fiscal and budgetary policy;

2. The development of new information and decision technologies has enlarged the applicability of objective analysis to policymaking; and

3. There has been a gradual convergence of planning and budgetary processes.

For a better understanding of the various differences between the budgetary orientations, a table is presented as follows:[3]

Table 10-1. Some Basic Differences Between Budget Orientation

Characteristic	Control	Management	Planning
Personnel Skill	Accounting	Administration	Economics
Information focus	Objects	Activities	Purposes
Key budget stage (central)	Execution	Preparation	Preparation
Breadth of measurement	Discrete	Discrete/ Activities	Comprehensive
Role of Budget agency	Fiduciary	Efficiency	Policy
Decisional-flow	Upward-aggregative	Upward aggregative	Downward disaggregate
Type of Choice	Incremental	Incremental	Teletic
Control Responsibility	Central	Operating	Operating
Management Responsibility	Dispersed	Central	Supervisory
Planning Responsibility	Dispersed	Dispersed	Central
Budget-Appropriations classifications	Same	Same	Different
Appropriations-organizational link	Direct	Direct	Crosswalk

III. LINE-ITEM BUDGET APPROACH

The line-item budget which dominated the U.S. federal government from the 1900's to early 1950's gives emphasis on listing of objects for itemized expenditures - supplies, personnel, equipment - without much regard for the purposes of programs for which such items are proposed. It is also called "Item of Expenditure Approach" as it controls expenditures at the department

or agency level with emphasis on the accounting aspect of governmental operations in terms of items bought or paid.

Line-item budgeting, a manifestation of process budgeting, is "incremental, fragmented, non-programmatic and sequential."[4] There is a tendency to accept the preceding year's budget as the base for the next year's budget; to use an array of non-analytic tactics to reduce the complexities and conflicts of budget- making; and to strengthen the opportunities of agencies to obtain funds. In this type of budgeting, there is little explicit consideration of objectives and policies and almost no search for alternatives. In line-item budgeting, the contestants tend to view the options from the perspectives of the established positions (existing position, last year's budget, the "base", etc.). There is a retrospective bias here and budgeting is treated as the process of financing existing commitment and of creating some new commitments.

According to Robert Golembiewski, line-item budgeting has percolate-up characteristics, that is, the chief executive issues a call for estimates which are generated from below.[5] The line- item is a product of many "factorings" beginning at low organization levels whose requests were aggregated and perhaps trimmed as they rose through an hierarchy. Consistent with the elemental motive of controlling expenditures, the line-item budget lessens the top executive's control over planning and programming. In fact, Golembiewski notes that the line-item budget's "factoring" is already a *fait accompli,* by the time it reaches the top executive.

With its unifunctional thrust, the line-item budget is concerned with its particular functions and neglects the others. The line-item structure effectively serves the control function by providing central budgeters with numerous opportunities and justifications for intervening in agency spending. In this control environment, management and planning are done tacitly, without any direct link to budget choice.

In the Philippines, line-item budgeting in government was adopted through the enactment of Commonwealth Act No. 2546, otherwise known as the Budget Act of 1937. This type of budgeting provided an administrative control of costs of inputs to government activities and projects. To that extent, specific items of expenditure were provided without relating them to any objective or output of activity. Efficiency in budget management was based on its ability to maintain ceilings per item of expenditure. No special thought was given to results generated from such expenses.

Strictly speaking, budgeting in a rudimentary form already existed when the country was under Spanish colonial domination. The system remained unaltered when America gained control over the Philippines at the turn of the twentieth century. Even with the Budget Act of 1937, providing the

framework of the "modern" budgetary system in the country, budgeting was considered a ministrant function requiring little technical expertise until after late 1950's.

On the basis of the United States' long experience in utilizing the line-item budget approach, Allen Schick was able to lay down ten advantages:

1. It enables central authorities to control inputs; that is, to control the cost of inputs before the expenditure is made or obligated.

2. It provides external control by legislators and central monitors who are not beholden to a particular agency.

3. Line-item control is specially effective for salaries and purchases, which together account for the bulk of state government spending, perhaps 90 percent or more in some instances.

4. Control is uniform. Each agency is governed by the same accounts and standards. A typewriter in Agency A has the same status and is subject to the same rules as a typewriter in Agency B.

5. Control is comprehensive. No item escapes control surveillance. Control covers all fiscal transactions of the government.

6. Control is exact. It can be imposed with pinpoint precision on the class of actions or expenditures that central officials want to control.

7. Control is routine. The records upon which control is built are required in the ordinary course of activity: purchase specifications, personnel actions, voucher approvals, travel authorizations, etc. There is no need for special intervention to impose control.

8. There are multiple opportunities for control. Central authority can be exercised at many points in the expenditure process and throughout the fiscal year.

9. Both aggregate and detailed control are promoted. Line-item supervision ensures that the expenditure ceilings established by law or administrative fiat will not be breached, but it also permits control to extend down to particular items.

10. Line-item controls establish the basis for budget cutting. To bring the budget into a desired relationship with income, central controllers are able to delete or reduce items until the target is reached.

Why do agencies, despite frequent disclaimers, prefer the line-item budget even with the introduction of the performance budgeting type in the 1950's? The answer to this is quite clear. Line-item budgeting gives agencies plenty of opportunities to manipulate the facts to their advantage and considerable leeway in estimating the projected benefits of proposed activities.

Agencies are able to express their subjective interpretation of anticipated benefits without being encumbered by analytical instruments. Nor are they required to weigh in a systematic and uniform manner the cost effectiveness of their proposals. Budgeting by object obtains "the best care" for the agency. An agency needs only to promise benefits to justify its requests.

At the same time, a line-item budget is very useful as a control mechanism. Under conditions of limited resources aggravated by problems of corruption, a control oriented budget is most helpful.

The Philippines' experience with the line-item budget marked a distinctive niche in the evolution of the various approaches in the country's budgetary system. During the legislation or authorization phase of the line-item budget, the legislature wielded so much influence on agencies of their choice. Through the line-item budget, the lawmakers were able to pinpoint "objects of future choice," especially those referring to new positions. Thus, even before actual authorization of agency budget estimates, compromises had already been bonded with various legislators. New positions had been reserved for their kin.

IV. PERFORMANCE BUDGETING

The ferment of the 1930's for better budgetary techniques by the Federal Government culminated in the performance budgeting recommendation of the Hoover Commission in 1949. The Commission coined the name; it did not invent the concept.[7] By giving a new label, "performance budgeting," to what long had been known as "activity" or "functional" budgeting, the Commission succeeded in creating a feeling of novelty and excitement for the post-war generation of public administrators.

The Hoover Commission Report to the U.S. Congress in February 1949 explained the meaning of performance budgeting:

> *"We recommended that the whole budgetary concepts of the Federal Government should be refashioned by the adoption of a budget based upon function, activities, and projects, this we designate as a performance budget.*

"Such an approach would focus attention upon the general character and relative importance of the work to be done, or upon the service to be rendered, rather than upon the things to be acquired such as personal services, supplies, equipment, and so on. These latter objects, are after all, only the means to an end. The all important thing in budgeting is the work or service to be accomplished, and what that work or service will cost."[8]

In performance budgeting, the objects of expenditures are deemed as significant factors in relation to what they are used for and not in relation to their specific character.[9] The objects of expenditure are linked to planned work or service. Thus, the accomplishment of the planned activity becomes the overriding objective of a performance budget. Other writers think that the performance budget's basic purpose is to enable administrators to assess the efficiency and the work of spending agencies. Its method is particularistic as it involves the itemization of data into discrete cost units.

The salient features of a performance budget and its basic differences from the traditional line-item budget are depicted in this comprehensive definition of the concept. A performance budget is one which states:

a) the short term and long term goals in the major functional areas for which funds are requested;

b) the programmes in each function and activities or projects in each programme proposed for the accomplishment of the goals in the various functional areas;

c) the cost of the programs and activities or projects proposed;

d) the qualitative and quantitative data for the program and activities proposed;

e) the organization units responsible for carrying out the programmes;

f) the sources and amount of all money receipts and expenditures; and

g) the units of work measurement which measure the results of programs, projects and activities.

A performance budget is in essence a work-plan of the government which specifies the concrete proposals to be accomplished during the financial year. It is formulated on the basis of work to be done or services to be provided by the government and presents these together with their costs. The performance budget is presented by the executive to the legis-

lative body and, after consideration and approval by the latter, becomes a theoretical contract between the legislative body and the executive authority; and within the executive, between the central budget agency and the administrative department responsible for carrying out the work. During the period of execution, to ensure the achievement of the planned work or service, the executive authority employs budgetary control through accounting and reporting systems. These systems serve as a continuous check on actual performance in terms of work as well as of expenditure against the approved budget.

A. *Components*

Performance Budget Techniques. Like all other budget approaches, performance budgeting has its distinctive methods. While these have not been described comprehensively in the literature, the main elements can be inferred from the practices of governments and the proposals of reformers. The common components of performance budgeting systems are: a) activity classifications, b) performance measurements, and c) performance reports.

1. **Functional and Activity Classifications**

Performance budgeting places considerable emphasis on redesigning expenditure accounts and grouping expenses into functional and activity categories. In performance budgeting technology, a function refers to a group of related activities for which a governmental unit is responsible. Functions such as public safety, health, and transportation, are divisible into specific groupings of work and expenditures. For example, the health activities of government include food inspection, the licensing of doctors, and the operation of clinics.

The classification structure used in each government is a product of fiscal, organizational, and political considerations. There is no universal classification scheme; each government is free to devise the system it wants and finds most feasible.

Classification of agency functions is not without problems or constraints. For one, when an activity is multi-functional, there are as many ways to classify it as there are functions, and the several classifications may be incompatible with one another. Another set of problems pertains to the relationship of the functional classification with the organizational structure. Even under performance budgeting, the organization is the basic appropriation and spending unit. There is no exception to the practice of preparing estimates, making appropriations, and controlling spending according to organization categories. Agencies, therefore, should synchronize their organization structures, budget classifications, and accounting systems.

2. Performance Measurements

Measurement is essential to the success of performance budgeting. Performance measurements generally are derivatives of cost accounting and scientific management. Adopted from cost accounting are methods of measuring the total or partial cost of each unit of production or service; from scientific management, techniques for relating units of input (such as labor) to quantities of output. In its application to government, cost accounting is more often used for ascertaining than for controlling costs.

The basic format of all performance measurement is the relation of inputs to outputs. Scientific management and cost accounting provide alternative ways of measuring inputs. The former measures the effort; the latter, the cost. In both types, outputs are stated in terms of the number of work units as a crucial step in measuring performance. Work measurement is impracticable or not useful when the output is heterogeneous, of varying quality, or unstable. The fact that many activities of government agencies can not be quantitatively measured in a meaningful manner poses a big problem in the smooth implementation of performance budget even in the United States.

3. *Performance Reports*

Reports are a special type of performance measurement, a retrospective assessment of what was accomplished with budgeted resources. The performance report can either be an interim-audit or a post-audit of work and costs. It compares the actual cost and accomplishment with what was projected in the budget. A performance report may show deviations thereby prodding managers or budgeters to take corrective actions. A report may also lead to a reappraisal of performance.

In recommending the adoption of a performance budget for the United States, the Hoover Commission pointed out several advantages of the new budgetary system:[10]

1. It gives more comprehensive and reliable information to the chief executive, the legislative body and the general public on the policies of government;

2. It helps individual legislators to understand what the government is doing and what the costs are;

3. It improves legislative examination of budgetary requirements and enables the legislative financial committees to decide more easily the basic expenditure issues each year;

4. It makes possible the submission and consideration of the budget for a shorter length of time;

5. It enables the administration to place responsibility upon subordinate officials for the clear execution of the provisions made by the legislative;

6. It permits effective performance in reporting on budgeting and management.

B. *Attitude Towards Performance Budget*

In the light of the underlying advantages of the performance budget type, favorable reactions towards its adoption was expected. However, there were accounts on some negative or indifferent attitudes towards performance budgeting in the United States. To begin with, throughout the performance budget era, there was persistent confusion over the meaning of performance budgeting and program; and others considered the program budget to be a step beyond the performance budget.

The decade-long American experience in performance budgeting, particularly in the three pilot states of Maryland, New York and Ohio, pointed to the limitations of this budgetary innovation. Obviously, performance budgeting was deemed salient by those who advocated it. But these were technical and management people, not budget and policy officials. Ten people in the top echelons of the state government regarded it as a matter of high priority. Thus, outside the small circle of reformers, no one provided forceful and sustained leadership. None of those involved in budgeting could see the advantage to be gained from performance budgeting and none were moved to give it strong support.

Performance budgeting was of marginal utility to the budget participants who followed their routines although cognizant of the need for change. Least affected and least interested were those on the periphery of budget life: legislators, operating officials, and governors. They had a vital stake in budget outcomes and also in the form in which the budget is cast, but none perceived performance budgeting as having a critical influence over form or outcome.

Performance budgeting meant the elevation of management concerns to central prominence. Yet if one were to rate participant interest in the control, management, and planning function of budgeting, management would score the lowest. "Who...cares how much a pound of laundry costs?", a New York legislator exclaimed when he was shown the detailed statistics produced by his state's performance budget project.

Budgeting should attract intense interest when it is used to maintain efficiency; but only few, mostly efficiency experts, are interested.

Performance budgeting also meant abandoning control traditions in which the budget examiners had strong interests and over which they served as guardians. In fact, majority of the budget examiners in New York believed that line-item budgeting had resulted in explicit, accurate budgets with a minimum of deficiencies and supplementals. In this respect, as long as budget officials continued to believe that there was no quicker way to know about agency thinking than to look at what was happening with line-items, "they would not view with favor the radical reforms promised by performance budgeters." Performance budgeting was castigated as too radical and too complicated, particularly with its over-refinement in details, which could obscure the prime purpose of an agency's program to the point that budgeting becomes a mere exercise in accounting.

In the final analysis, budgeters felt that it made little difference whether one method or another was used because, during the period of the performance budget experiment, they merely went through an exercise in accounting. Expressing faith in common sense in contrast to scientific budgeting, traditional budgeters, asserted that "budgeting is 90 percent common sense and don't let anybody tell you anything else."

While American policy-makers, officials, budgeters, and the public were still in a quandary as to the validity and full acceptance of performance budgeting, the growing interest in other countries was quiet evident. Among the developing countries which welcomed the idea, the Philippines stood out. The Philippine government enthusiastically requested United States experts to introduce the concept to the country. Never before was the evolution of the Philippine budgetary system as colorful and memorable as with the country's experience in performance budgeting.

C. *The Philippine Experience in Performance Budgeting*

Cognizant of the lag in the development of public fiscal management in the field of budgeting in the early 1950's, the Philippine government took concerted efforts to improve the budgetary system. The move was towards a more systematic pattern of allocating available funds among competing public expenditure requirements. The budget, accounting and auditing modernization project was launched in July 1954 in collaboration with the United States management consultancy firm of Booz, Allen and Hamilton. Project costs were underwritten jointly by the U.S. and Philippine governments. Like other reform projects implemented under the broad United States technical assistance program in the Philippines, budgetary improvements represented an attempt to initiate requisite changes in an area relatively neglected in the past.[12] However, it differed from other programs

in that it involved a technique that was untested in other jurisdictions: performance budgeting.[13]

In effect, performance budgeting was introduced in the Philippines as part of the package of reforms which was initiated during the incumbency of the late President Ramon Magsaysay by the Economic Survey Mission headed by Daniel Bell in 1950.[14] The purpose of the reforms, including the modernization of fiscal administration, was to help the government cope with the severe social, economic, and political problems. The implementation of the administrative reforms was part of the conditions imposed for the granting of further foreign aid.

The passage of Republic Act No. 992 or the Revised Budget Act on June 4, 1954, formally launched the establishment of performance budgeting in the Philippines. This Act required that the whole budgetary concept be based on a triad of functions, projects, and activities defined in terms of expected results. This Act also directed the modernization of the accounting system. The American management consultancy firm, Booz, Allen and Hamilton, was hired to train and conduct workshops on the performance budgeting method.

A performance budget was devised and scheduled for implementation in twelve executive agencies for fiscal year 1956 while other 68 offices were scheduled for FY 1957. This signaled the change from the old line-item budgeting which was in force since 1937 to the performance budget in less than two year of crash training under the tutelage of the American "experts."

The budget proposal was vigorously objected to by a number of Congressmen. They feared the loss of control by them of the "purse" since the budget would now have to be presented in the form of programs and projects and lump sum estimates.[15] Despite the spirited opposition, the performance budget was adopted.

But how successful really was budgeting through the performance concept? As in the United States, despite the advantage and benefits it purported, performance budget was not free of criticisms and weaknesses in the Philippine setting. Four years after experimenting with the new budget system in the pilot agencies, congressmen pointed to the weaknesses which centered mostly on data presentation. A related weakness or problem was the lack of knowledge on performance budgeting among the congressmen. While the legislature appeared in favor of performance budgeting, there was an attempt in 1963 to completely dislodge it from the Philippines. The proponents of the abolition of performance budgeting were the same proponents for its abolition in 1953. Among the reasons cited was that the President submitted a performance budget while Congress worked on a line-item version. This exercise was frowned upon as a farce.

For their part, the executive agencies pointed to two factors which they believed made performance budgeting unsuccessful: a) indifference in the execution of programs, and b) lack of understanding on the part of key operating officials. On the other hand, outside of government, everyone seemed to be unanimous in the observation that certain fundamental administrative problems in the Philippines would block the successful and complete implementation of performance budgeting. These problems included areas of performance measurements, personnel, organization and the role of the legislature.[16]

1. Lack or Absence of Performance Measurements

Units of work measurement characterize performance budgeting. While line-item budgeting merely lists the items of expenditures, performance budgeting is based on programs, projects and activities. The formulation of precise and accurate units of work measurement is the most critical problem. This stems from the fact that many activities could not be quantitatively measured in a meaningful manner, especially if the outputs of agencies are heterogeneous. In fact, up to the present, this problem on work measurement has not been completely solved. The Department of Budget and Management has been in an endless search for exact work measurement units on which to base the financial requirements of government agencies. The unit of work measurement is the very essence of performance budgeting as it measures the results of agency programs and activities. It cannot be denied, however, that the attainment of accurate work measurement units depends largely on a common understanding and framework between the central budget agency and the operating agencies.

2. Personnel

Performance budgeting is hampered by the lack or absence of personnel possessing necessary technical skills and competencies such as management and cost accounting. The responsibility for preparing the budget shifts from the accountants to the manager who has to express his agency's plans in terms of programs and projects.

In addition, performance budgeting demanded a tremendous amount of cost data which was not available at the time the system was installed. The accounting system as earlier set up by the Americans was not at all cost-oriented and it was only recently that cost concepts have been introduced into the system. In view of the incompatibility between the accounting system and the desired cost data, a meaningful performance budget was hardly achievable.

3. Organization

Performance budgeting demanded no less than a restructuring of the government's organizational system. Unfortunately, Congress rejected many of the reorganizational plans presented in 1955 and 1956. Out of 50 plans presented in 1955, only one was approved. And out of 53 plans presented in 1956, 20 were rejected. For those plans which were passed into law, complicated problems led to an overweight, overstaffed, and inefficient bureaucracy. This necessitated a massive government reorganization in 1972. Such frustrations in streamlining the government's organizational structure impeded the success of performance budgeting which requires a logical, rational, and efficient organizational structure.

4. Legislature

Lack of congressional support added to the unsuccessful implementation of performance budgeting. Initial support leading to R.A. No. 992 eventually changed to downright hostility on the part of the Congress. Honesto Mendoza, a leading authority on Philippine budgeting, remarked that "the most depressing reason for the present superficial adoption of performance budgeting in the government is the complete reversal of Congress with respect to performance budgeting." Failure to take into account the realities of the political system at the time performance budget was installed aggravated the problem. The same political parties that prevailed during the pre-performance budget period also ran Congress after the system was installed. Thus, the performance budget was considered more as a source of information for new positions and vacancies which could be made available to favored supporters.

To a large extent, the above problems indicate that performance budgeting was adopted in form but not in substance. The budget was not useful in solving the severe economic problems plaguing the Philippines at the time. Budgeting remained as an administrative control measure and not as a tool for the implementation and formulation of developmental fiscal policy. In addition, the American consultants emphasized changing first the format of the document; the preparation of the manual was done later. Mendoza observed that performance budgeting is not the end product of an already operating budget system, but a forerunner of a system that needs to be tested in practice. Cost accounting systems and cost standards were not yet installed. Only a few Filipino staff members were really initiated into the working of the system.

In short, local practitioners got the impression that performance budgeting was merely a change in format and not necessarily a concept of a developmental budget. What were considered as data were merely inferences and guesses. The units of work measurement were merely estimates.

Local critics of the new system claimed that performance budgeting was "the same animal-only bigger". It was also in 1977, after 23 years, that a "purely" performance-type budget was finally produced with the passage of the CY 1972 General Appropriations Act under Presidential Decree No. 1050.

Today, performance budgeting is in force at the national level. However, local government units are still struggling with this system. They complain that they are too small to operate on a performance budget. Aware that the national government took 23 years to finally implement performance budgeting, local government units wonder how long it will take them to achieve the same.

In the light of the foregoing discussion, it must be emphasized at this point that the advantages and merits offered by performance budgeting cannot replace the many judgments which must be made in formulating a budget for development. Neither is the quantitative and qualitative information which performance budgeting attempts to provide a substitute for effective supervision at the various levels of government organization.

At the same time that both developed and developing countries were grappling towards a successful implementation of performance budgeting, the search and advocacy for a more improved or modern budgeting approach continued with a sense of urgency. Newer approaches to budgeting ensued because of the realization among executives and legislators of the deficiencies of the traditional line-item budgeting and the weaknesses posed by performance budgeting.

The deficiencies of conventional budgeting pointed to its limited focus on how much the government gets and spends; thus the emphasis on the personnel component. Even with the introduction of performance budgeting, the relationship between output and inputs remained unspecified. Therefore, there was difficulty in identifying the specific output (ends or purposes) and in defining what inputs (means) were needed. In other words, despite claims by government officials that they advocated performance or program budgeting, there was a tendency, for developing countries particularly, to be unclear in the objectives they wanted to achieve. Budgetary programs were not integrated but were only collations of the different budgets of the government agencies.

V. PLANNING, PROGRAMMING AND BUDGETING SYSTEM

A. *Emergence of PPBS and Its Features*

The Planning, Programming, and Budgeting System was originally developed by the Rand Corporation in Sta. Monica, California, for use by the United States Air Force. PPBS was adopted in 1961 by the Defense

Secretary Robert MacNamara for his department's operations. Finally in August 1965, then President Lyndon Johnson issued an executive order instructing all executive departments to adopt PPBS; thus making this system the decision-making and financial tool of the federal government.

PPBS is a result of three distinct but closely related current thoughts in budget-making: economic planning, efficiency in government, and management of national economies to control cyclical fluctuations. PPBS recognizes that planning and budgeting are complementary in character. The system responds to the need for an economic allocation of resources and the effective conduct of government policy. Program analysis and cost utility analysis have been developed to sharpen the policy- decision process.

PPBS also offers an answer to the classical question: How does the government allocate resources appropriately and rationally without resorting to a hit-and-miss procedure? PPBS respond to the question by eclectically incorporating in the system three distinct administrative processes, namely: strategic planning, management control, and operational control. Corollary to this, Allen Schick notes that PPBS is predicated on the primacy of the planning function; yet it strives for a multi- purpose budget system that gives adequate and necessary attention to the control and management areas.[17]

Even in its embryonic stage, PPBS envisions the development of cross-walk grids for the conversion of data from a planning to a management and control framework and back again. PPBS treats the three basic functions as compatible and complementary elements of a budget system, though not as co-equal aspects of central budgeting. In ideal form, PPBS centralizes the planning function and delegate primary managerial and control responsibilities to the supervisory and operating levels, respectively.

For Jack Rabin, PPBS is a rational decision-making technique which may be used to make more systematic decisions, given a set of objectives and information at hand.[18] He states that PPBS emphasizes the long term benefits and costs of a program, not the short-term. PPBS is composed of program budgeting and systems analysis which typically involves cost-benefit studies. Program budgeting places into common categories all activities necessary to accomplish some broad project or program. Thus, the focus of PPBS is on the uses of government expenditures and on outputs rather than on the dollar or peso amounts allocated by agency or department.

A useful definition of PPBS includes the purpose of the system. David Ott and Attiat Ott[19] state that the aim of PPBS is to specify (and where possible to quantify) the objectives or "output" of government's spending programs and then to minimize the costs. To do so requires the systematic use of analysis in connection with budget formulation, planning, program development and evaluation. Arthur Smithies defines the purpose of PPBS

as follows:[20] a) to improve the basis for major program decisions; b) to subject decision about resource allocation to systematic analysis, comparing alternative courses of action in a framework of rational objectives clearly and specifically stated; c) to use the rule of efficiency in choosing the alternative that optimizes the allocation of public resources; and d) to help responsible officials make decisions while taking into account that PPBS is not a mechanical substitute for the good judgments, political wisdom and leadership of those officials. Clearly one of the major aims of PPBS is to convert the annual routines of preparing a budget into a conscious appraisal and formulation of future goals and policies.

B. *Specific Features*

On the basis of some operational definitions and avowed purposes of PPBS, the specific features of the system are summarized below:[21]

1) Specification of objectives to be achieved through government spending and expenditures;

2) Existence of a multi-year planning and programming process which incorporates and uses an information system to present data in meaningful categories essential to major executive decisions, thus a budget system which is future and planning-oriented;

3) Selection of a decision from various alternatives to achieve program objectives where the choice is arrived at using economic method of analysis such as cost-benefit analysis and feasibility studies which leads to minimization of costs and comparison of costs and benefits, especially when benefits can be quantified.

4) Existence of analytic capability used by the agency's by permanent specialized staffs to meet objectives.

5) Existence of a budgeting process which can take broad program decisions, translate them into more refined decisions in a budget context, and present the appropriate program and financial data for presidential and legislative action; and

6) Systematic use of analysis throughout the process, hence holistic and integrative in approach requiring economic and planning skills.

C. *PPBS: The Philippine Experience*

Just like its predecessor, performance budgeting, the introduction of PPBS brought a damaging gap between publicity and performance. In the United States, agencies went through the motions of preparing PPBS

documents.[22] The regular submissions got all the attention while the analysis and plans were disregarded. Despite the status of PPBS in the United States, other countries were not deterred from adopting the system.

In the Philippines, after the declaration of Martial Law in September 1972, P.D. No. 1 called for the reorganization of the entire government system in accordance with the Integrated Reorganization Plan recommended by the Presidential Commission on Reorganization. The same P.D. provided for the creation of the National Economic and Development Authority (NEDA) chaired by the President himself. NEDA's primary task was to formulate short- term and long-term development plans and to monitor the implementation of such plans. The emergence of NEDA as the superbody on development led to what is popularly described as the "primacy of planning". The government's advocacy for development planning linked with the budget process rationalized the adoption of PPBS.

As in the United States, the PPBS doctrine was first initiated in the Philippines by the military.[23] Military officials who were sent to the U.S. were given training in the system. In turn, these officials endeavored to implement it in the local military. The Philippine Navy attempted to work out a PPBS model for the entire Department of National Defense (DND) in 1976. At the same time, the DND started a one-month PPBS orientation program for its executives in cooperation with the University of the Philippines. The DND intended to have the orientation program followed by seminars and workshops for technical people. Even project management courses of the National Computer Institute included the introduction of PPBS.

As a result of the exposure to PPBS, Filipino scholars and experts read papers in seminars on the possible usefulness of PPBS in the Philippine setting. No less than former Finance Minister Cesar Virata remarked on the possible usefulness of PPBS to less-developed countries. The leading organization of budget officials in the country, the Philippine Association of Government Budget Administration (PACBA) devoted several conferences to a discussion of the merits of PPBS. Even the Career Executive Service Development Program undertaken by the Development Academy of the Philippines invariably included an overview of the PPBS in its course modules. Likewise, course syllabi in fiscal administration, organization and management, and management planning and control courses in the University of the Philippines' College of Public Administration included assessments of PPBS.

Early proponents of PPBS in the Philippines avoided using the term to minimize negative reactions to another "imported technique." They preferred to call it the IBS or the Integrated Budget System. Despite such incognito, it was implied that IBS or PPBS, like the performance budget, was the same animal, only much bigger this time. Local budget officials were

very careful about openly advocating PPBS, perhaps due to the earlier experiences with performance budgeting. However, they admitted the usefulness of the system in this sense:

a) PPBS provides a clear linkage between planning and budgeting; and

b) PPBS offers techniques which might help solve the problem of resource allocation and settling of positions.

Still there persist problems in fully implementing PPBS. The data requirements of the system involves adjustments in the present organizational structure for budgeting. PPBS also requires computerized data which are beyond the technical and financial capabilities of many government agencies. Economic tools of analysis called for by PPBS such as feasibility studies, cost-benefit analysis, and cost-utility analysis require data inputs and skills which budgeters may not necessarily have at present. Likewise, PPBS calls for a shift in orientation from management and accounting to a planning orientation. Finally, the implications of PPBS upon decision-making wherein decision- making on policy options is allegedly shifted to the technocrat- planners is a source of spirited debate.

At this juncture, what really are the prospects of PPBS in developing countries? There is no doubt that a lot of developing countries are attracted to PPBS because it is an attempt toward achieving rationality in decision-making and allocation of scarce resources. By providing avenues for long term planning PPBS hopes to enhance technical skills and capabilities of planning and budget personnel.

The shift from popular decision-making and participation to management by a few technocrat-planners is a significant factor that necessitates thorough analysis and consideration. Will these technocrats embody and represent the general will? Do they have a feel of what the citizenry really needs and wants? On top of this, the information requirements of PPBS are essentially data-based, hence the need for a management information system. The installation of a sophisticated MIS could be a drain on the limited coffers of developing countries.

D. *An Assessment of PPBS*

Compared to the critics of performance budgeting, the critics of PPBS are more outspoken and emphatic in their assessment of PPBS implementation. Topping the list is Aaron Wildavsky whose appraisal of PPBS and politics of the budget process may now be considered a classic[24] and from whom a lot of scholars on government budgeting owe a lot.

Schick and Wildavsky have observed that PPBS has never influenced governmental decisions according to its own principles. The program structures do not make sense to anyone. They are not in fact used to make decisions of any importance. Such products of social desirability to whatever was noticeably superior in analytic quality or social desirability to whatever was done before. To give PPBS the potential to succeed, there should be "sufficient" conditions. The critical assumption therefore is that it is easy to set up PPBS but difficult to implement the system. The problems presumably lie in rooted interests, recalcitrant politicians, and hidebound bureaucrats. The implementation of PPBS has also been hampered by lack of trained manpower, absence of essential data and even inadequacies in cost data.

According to Wildavsky, putative defects can be remedied. Training can be stepped up, politicians and bureaucrats can be replaced to better ones, better data can be collected, and methods of analysis can be improved. If these were the only problems, it would be difficult to explain why PPBS has no success to its credit. For surely somewhere, the sufficient conditions for PPBS exist. But it does not work just the same. Why? To this, Wildavsky answers that the disabilities of PPBS occur not merely in program implementation but in policy design itself. Its defects are in principle, not in execution. PPBS has failure built into its very nature because it requires the ability to perform cognitive operations that are beyond present human or mechanical capacities. In this respect, it also seems that the conditions and the environment in which PPBS opts to operate are rather esoteric.

Other writers further observe that "there is...little news in the individual concepts of the PPBS. What is new is the combination of a number of these concepts into a package and the systematic application of the package in toto to government planning."[25] Where PPBS employs the use of Operations Research or Management Science, Victor Thompson strongly remarked that "...science cannot solve social problems. Suppose for example, that we ask medicine to solve the problem of race prejudice. As a medical problem the "solution" might turn out to be some drug. However, the social problem would still remain...The solution of a social problem is properly described with such words as "compromise', 'consensus', 'majority', 'negotiation', 'bargaining', 'coercion', etc. If the solution cannot be described in such terms, then it is not the solution of a social problem."[26]

Such observations reinforce the fact that PPBS is not really an embodiment of rationality. It shifts decision-making from congressmen to a handful of technocrats or "econologists" who may not necessarily represent the general interest of the people. This problem is compounded by an element of uncertainty since the environment changes in a frenetic pace. Thus, a PPBS which envisions all sufficient conditions and a more or less stable environment may find itself confronted by a hostile, competitive environment.

Otto Eckstein says that PPBS is difficult to fully implement in "mixed" economies or developing countries like the Philippines.

A positive view of PPBS is noteworthy. Although presenting no panacea, PPBS offers a logical, objective approach to planning and budgeting. Potentially, PPBS allows administrators to evaluate the anticipated results of proposed programs and systems alternations, and to compare results from different proposals in search of a "best" or "satisfying" alternative.[28] With that, one should recognize the fact that PPBS is only a tool for budgetary forecasting, planning, and programming. The tool never makes decisions; decision-makers who use the data derived from the tool make the choice.

VI. ZERO-BASE BUDGETING (ZBB) APPROACH

A. *Introduction and Definition of the Concept*

The zero-base budgeting approach "revolutionized" the budgetary systems in both developed and developing countries. As usual, the trend-setter was the United States, and its gospel was echoed and adopted by many developing countries.

The ZBB concept could be traced back to 1924 in the United States, when a certain E. Nelson Young criticized the practice of taking last year's estimates for granted and just adding increased expenditures to it. The first formal and comprehensive zero-base budgeting system was designed only in 1964 by Peter A. Phyrr. That was when a private firm, Texas Instruments, Inc., adopted ZBB in its annual budget preparation. Later it was adopted in Georgia by Governor James Carter who, after winning the U.S. presidential elections, introduced the system for adoption throughout the federal government.

What is zero-base budgeting? According to Peter A. Phyrr it is "an operating, planning and budgeting process which requires each manager to justify his entire budget request in detail, and shifts the burden of proof to each manager to justify why he should spend any money."[29] In other words, ZBB is a management and budgeting process which necessitates each manager responsible for a major activity, cost center or function to justify fully his budget proposal following a systematic method of identifying, analyzing, evaluating, and ranking present and new projects. As a variety of what may be generally called comprehensive budgeting, ZBB calls for the analysis of all budgetary expenditures to assess effectiveness in achieving organizational goals. It is part of the long search for a rational method of allocating resources and setting priorities. In effect, ZBB seeks to supplement PPBS in the setting up of priorities for government expenditures.

Conceptually, the term "zero-base" refers to the yearly analysis, evaluation,and justification of each activity, program or project starting from a "zero" performance level. For the uninitiated, the term "zero" in budgeting connotes a negative impression. However, "zero-base" really means the analysis of the entire budget from a starting point of zero or from "scratch".[30] The idea is to "zero-in" on only the most important elements, projects or activities for inclusion in the budget or on the least important or lowest-priority activities which may be scrapped in the event that resources would not be enough. This way, the most important projects may succeed with adequate funding rather than distribute the resources thinly among many activities and achieve nothing in the end.[31]

B. *Features and Objectives of ZBB*

On the basis of the literature on ZBB emanating from the United States and observations of the concept as operationalized, the Ministry of the Budget (now Department of the Budget and Management) summarized the main features of ZBB as follows:

a) It is a total budget approach. All activities proposed, whether existing or new, are analyzed, evaluated and justified rather than just increased from current operating levels.

b) It is a budget based on need, not want. ZBB requires that all activities proposed be analyzed and evaluated systematically without reference to past practices. Program goals based on constitutional mandates and enacted to meet problems or needs that are of lesser priority today should be reevaluated in terms of present conditions.

c) It reallocates resources. ZBB shows where resource should be allocated to ensure attainment of objectives.

d) It identifies alternative ways and levels of performance and funding. ZBB challenges each manager to look for alternative ways of performing an activity.

In effect, the ZBB system hopes to achieve the following objectives:

a) strengthen the present performance budgeting system by the application of systematic analysis and techniques to budget formulation;

b) eliminate or reduce the funding of low-priority activities in order to fund high-priority ones;

c) improve the quality of management and budget information; and

d) encourage the application of improved or new performance measurements.

C. *Basic ZBB Terms*

A number of terms used in ZBB are provided hereunder with some operational definitions:[32]

A **Decision Unit** is a major activity, group of related activities, cost center or organizational unit which requires significant managerial decisions on performance and funding levels.

The **Decision Level** is the level of the organization responsible for analyzing, reviewing, ranking, and grouping activity justification document. Each division, regional office, and bureau are required to analyze and rank activities.

The **Levels of Performance and Funding** consist of three parts, namely:

a) *Current Level* (CL) - level of performance and funding that is required to carry on the current year's service or output level without major policy changes; also referred to as "business as usual" level.

b) *Minimum Level* (ML) - level of performance and funding below which an activity is not feasible to operate because it cannot make a constructive contribution towards fulfilling an objective.

c) *Enhancement Level* (EL) - the level of performance and funding above the current level wherein increased output and service will warrant the serious review of higher management; the enhancement level may be divided into EL(1) and EL(2) where EL(2) is higher than EL(1) and is closer to attaining completely the objective of an activity.

The **Activity Justification Document** (AJD) Decision Package is a document that identifies and describes a specific operation in a manner that enables management to evaluate and rank it against other operations competing for limited resources and to decide whether to approve or disapprove it.

An AJD contains all three levels of performance and funding besides the following information: objectives, description of activity, alternative me thods considered, and output performance measurement.

Ranking is the process by which higher level managers evaluate an array of activity levels (as shown in the decision packages) in descending order of priority.

D. *The ZBB Process*

Strictly speaking, eight detailed steps are necessary to establish the ZBB process in an agency. These are:

(1) development and issuance of agency planning assumption and policy guidelines;

(2) identification of decision units;

(3) identification of objectives for each decision unit;

(4) identification and evaluation of alternative methods of accomplishing objectives;

(5) analysis of different levels of performance and funding;

(6) preparation of activity justification documents or decision packages;

(7) ranking of activities at various performance and funding levels; and

(8) consolidation of activity justification documents and accomplishment of standard budget preparation forms.

However, the ZBB process can be simplified into two major steps: development of decision packages and ranking.[33]

In developing policies and planning assumptions, one should include development and budgetary thrusts for the budget year; anticipated budgetary ceiling; policy on wage and salary increase; delineation of responsibilities of departments, their bureaus and regional offices; and performance targets for the coming year.

For decision units, take activities that are not so low or detailed as to focus too limited options for decision-making, and not so high or broad as to hide major activities and commitments. Consider the time required for analysis and amount of paper work needed.

Set objectives for each activity. They must be operational, measurable and related to the agency's mission. A well-stated objective answers the questions "what" (response to issue or problems), "how much" (rate of response) and "when".

Once the AJDs are developed and packaged, the next critical step follows: the ranking process. This is done at different levels in the organization. Phyrr stresses that the ranking process has to be started by the manager who directly supervises the operation. Then the manager above him reviews the ranking and consolidates the ranking of all the packages of managers below him. The ranking is repeated upward until a final ranking is produced at some appropriate organizational level. Two routes are suggested for this ranking process - (1) based on the organizational structure and (2) by functional groupings of activities even if such activities cut across present organizational boundaries.[34]

Some fundamental questions associated with the ranking process are: (1) Who will do the ranking?, (2) How will it be done?, (3) What will be the basis for ranking?, (4) What ranking methods will be used?, and (5) How will the results be presented? Well-defined and objective answers to these questions will rationally lead to a meaningful ranking process.[35]

Invariably, the heart of ZBB is the ranking process.[36] All decision packages are listed in the order of decreasing benefit by the managers in charge of them. Since each package has a price tag attached, there is a cumulative cost as the list proceeds in descending order. Thus, an overall level of funding can be set and a line can be drawn at that level on the ranked list. Those packages falling within the line will not be funded. This brings the focus on or above the cut-off line.

E. *ZBB in the Philippines*

The ZBB system and techniques were introduced in the Philippines in 1977 during the preparation of the Calendar Year 1978 national budget. Since then the ZBB approach had been adopted in the preparation of annual budget estimates.

The legal basis of adopting ZBB is found in Section 8 of PD 1177 (Budget Reform Decree). It requires that agency proposals be reviewed on their own merits and not on the basis of a given percentage or peso increase or decrease from a prior year's budget level, a given percentage of the aggregate budget level and other similar rules of thumb that are not based on specific justification.

In directing the application of the ZBB approach during the CY 1978 budget analysis, then Acting Budget Commissioner Laya asked analysts to establish "bench marks" for outlays category: (a) personal services, (b) maintenance and operating expenses, and (c) equipment. Laya advised that, for maintenance expenses and equipment particularly, analysis must start from a zero-base and build up to a level proportionate and equal to the cost and benefit priority scale. It is better that a 'bench mark' be established

for each category rather than proceed to evaluate requests equal to or in excess of previous limits.[38]

Although American in orientation, the ZBB approach was introduced in the country by a group of Filipino officials who traveled to Washington; conferred with the United States Office of the Budget officials; and studied the ZBB techniques and adopted it to the Philippine setting. However, the method used in shifting to the new approach is disturbingly similar to the performance budgeting experience.[39]

What was revised first was the format of the budget. Hardly was there a consideration of changes in the budgetary system of organizational structures that would support the adoption of ZBB. One wondered whether the present data system of the government could generate inputs required for a rational identification of priorities.

What are the justifications for adopting ZBB in the Philippine Budget System? The reasons advanced by the Office of Budget and Management include, among others:

a) *Lack of managerial involvement in budgeting* - Some managers look at budgeting as a mere exercise. Sometimes, only a budget or planning officer prepares the agency budget. Managers are surprised when their offices run short of funds for priority projects or when they face budgetary constraints which they did not anticipate or understand during the budget preparation. ZBB tries to correct this.

b) *Limited priority setting of projects and activities* - Revenues do not always match fast-increasing government expenditures. Borrowings have limitations. Hence, government activities must be prioritized and scheduled in order that resources may be more effectively used. ZBB provides a mechanism for it.

c) *Lack of performance measurements and cost benefit analysis* - For many projects performance measures are meaningless. Cost-benefit analysis is hardly done. ZBB emphasizes the need for effective performance measures and cost-benefit analysis. It places responsibility on the manager in charge of an activity to qualify and quantify his performance outputs and compare the benefits derived from the activity with the cost of undertaking it.

d) *Unnecessary spending* - Most agencies use year-end "savings" for necessary travel expenses, supplies, training, seminars and low-priority expenses. With ZBB, an agency may allocate enhancement levels of approved priority projects.

e) *Weak planning and budgeting linkage* - Agencies do not always follow their plans. One cannot always identify what portion of the plan is achieved with the past year's expenses. ZBB starts from planning and strengthens the planning and budgeting linkage.

f) *Inadequate probing of organization and methods of operation* - Government agencies seldom scrutinize their organizations and methods of operation. With ZBB they can analyze correctly their organizational structure, personnel complement, responsibility assignments, and methods of operation.

g) *Ineffective allocation of resources* - Although much has been done to improve resource allocation to sectors, departments and programs, a lot could still be done at the project and activity levels where actual performance outputs are produced.

Based on the above conditions, one may safely state that ZBB is not a substitute for most of the other budget methods, like performance budgeting or PPBS. Rather, ZBB complements them. It neatly brings together in one system management principles, approaches and methods required for effective planning, budgeting and decision making.

In order to keep up with the requirements of this new budgeting approach, budget and planning technicians of various agencies were given training in ZBB concepts and techniques. The Office of Budget and Management spearheaded and conducted a nationwide series of training programs on the application of ZBB to agency and national budgeting. Actual exercises illustrating the filling up of ZBB forms, particularly those referring to the various levels of performance and funding, highlighted these ZBB seminars and workshops. In addition, ZBB was a major subject in a number of executive planning fora. ZBB gained so much popularity and interest that it was even discussed in various symposia or meetings which did not necessarily zero-in on the ZBB subject.

F. *An Appraisal of ZBB*

Reaction to the ZBB techniques, as with other new budgetary techniques, were mixed or varied. The following account described the U.S. experience on ZBB.[40]

At Texas Instruments, Inc., where the ZBB concept was conceived, some of the benefits claimed after the implementation of ZBB are: (1) The number of budget forms were reduced, and (2) ZBB provided a procedure for focusing evaluation of resources only for those activities with the highest contribution to profit.

In Georgia, advantages are associated with the use of ZBB. These are (1) the establishment of a financial planning phase before the budget was prepared; (2) greater involvement in the budgetary process by personnel in the lower organizational levels of State Government.

On the negative side, the experience of New Jersey as shown in a report published by the Council of State in the United States was not favorable. Problems were encountered in the following areas: (1) resistance to the system, (2) lack of understanding of the basic concepts of ZBB, and (3) poor quality of information submitted.

However, some report that, in general, favorable experiences exceed the unfavorable ones. This might be one of the reasons that convinced then President Carter to adopt the ZBB approach in the federal government.

At the federal level, Allan Schick has argued that the adoption of ZBB was remarkably successful because it was not separated from the usual process of budget preparation.[41] The irony of this is that ZBB did not really change anything; its adoption was superficial. Schick concludes that ZBB is not very useful for the reexamination of basic program objectives, but it may lead to the development of more efficient operational methods.

In the Philippine experience, top officials waxed enthusiasm about ZBB innovations. Significantly, no less than former Budget Minister Laya remarked that "the basis for ZBB is not really zero. Analysis of the zero-base budget is actually incremental or marginal in approach. For how will an answer be arrived at to a question like, 'How can this activity be sustained?' but through an incremental analysis. In this process, ZBB is a compromise, in itself."[42]

The same observation was articulated much earlier by Armand V. Fabella, Chairman of the Presidential Commission on Reorganization. Fabella believed that ZBB is still incremental because decisions are still made at the margin, that is, in identifying different levels of effort, the incremental costs of decision packages become the focus of decision-making.[43]

The only difference between traditional incremental budgeting and ZBB is the starting point. Under ZBB, all expenses of the agency are listed and justified. Under incremental budgeting, the assumption is that anything spent last year can be renewed without too much of a fuss and what require careful scrutiny are only additions to the budget plan. This approach does not force a reexamination of the methods of performing present activities.

With regards to the question of linking-up action with the country's development plan objectives, the position of the Office of Budget and

Management was very positive. Then Budget Deputy Minister Manuel Alba pointed out that "the concept of zero-base budgeting is consistent with the integrated development approach because ZBB promises performance. A long-shot concept behind ZBB is that it prescribes a much more competent presentation of a project because ZBB requires the proponent agency to justify the magnitudes and components of the projects."[44]

Weaknesses or constraints in full implementation of ZBB in the Philippine system stem essentially from certain prerequisites for its adoption. Fabella points out these requirements: (1) support from top management (2) translation of the concepts, and (3) management of the system. The first one is obviously assured if one is to think of the top management of the Office of the Budget and Management. Claudio has added certain requirements such as: (1) clear-cut organizational structure which defines duties and responsibilities of each manager; (2) clearly stated functions and objectives of the department or bureau; (4) competent managers; and (5) well-defined guidelines and planning assumptions. The absence of such preconditions impedes the ZBB process, particularly in developing the decision packages and ranking of each. At present most of the prerequisites are yet to be attained.

Fabella notes that ZBB has wide-ranging implications on organizational structure. Budget officials, including those at the agency level, have to be trained thoroughly in the technique. A more serious implication is that ZBB might result in continuous reorganization. This apprehension is valid because the organizational structure will have to follow the requirement of selecting decision packages. This might introduce insecurity and lack of permanence in the organization.[45]

Finally, Fabella notes that the distinguishing feature of ZBB, the ranking process, could be its Achilles heel. Ranking and evaluation of the decision packages must be done by men of proven expertise in the activities to be ranked and of unquestioned level of integrity.[46] Ranking calls for high-level objectivity, soundness of judgment, and competence of those ranking the decision packages.

At this point there is no denying the fact that conceptually ZBB makes sense. It is very rational. It forces people to think rationally, to use an intellectual approach, and it eliminates the inherent waste in doing incremental budgeting.[47] In its execution, however, budget officials have to recognize the following defects or weaknesses:

a) insufficient training of agency personnel on the intricacies of implementing ZBB;

b) lack of guidance in implementing ZBB, especially in the ranking system;

c) lack of central staff fully trained in ZBB so as to guarantee an effective reecho or orientation to agency budget and planning personnel;

d) lack of appreciation and real support from departmentheads and officials;

e) emphasis on forms or too much paperwork; and

f) difficulty of translating or operationalizing the ZBB concepts to more comprehensible, concrete terms which are socially digestible and palatable to end-users.

VII. CONCLUSION

The Philippine experience in applying various approaches to budgeting has been described. These were adapted from approaches developed in the United States - starting with the line-item budget, then the performance budget, on to the PPBS and ZBB.

What budget approach are we actually using in the Philippine budgeting at present? The chief of a financial management office of a leading agency, when confronted with this question, answered: "At the agency level, we are actually subjected to all these approaches. In budget preparation, we are enjoined to use ZBB; in budget authorization and accountability, it is performance budgeting which sets the standards. In actual implementation, it is still the good old line-item budget. The OBM holds us to the line-item budget and rations out our CDC's on this basis. Why is the line-item budget still used in actual implementation of the budget? Perhaps, it is still this type of budget which is the most useful tool when revenues are not collected as projected, expenditures soar uncontrollably, and unprogrammed projects are launched!

A few observations can be made on budgeting approaches used in the Philippines. First, these are from the United States. There is nothing inherently wrong with adapting budgetary approaches from other countries. After all, one cannot quarrel with a concept. Still, there have been very serious problems in adapting these approaches. The case of performance budgeting is the most interesting in the sense that it took more than twenty years before it could be substantially implemented. Secondly, it cannot be claimed with great confidence that these approaches have been completely

successful in making the budget an effective instrument of fiscal policy. There are projects and activities which are beyond the pale of the budgetary system. Budgetary decisions are made directly by the President in response to crises, unprogrammed needs and so on. Thirdly, these approaches are premised on rationality. Admittedly, there is a pressing need to introduce rationality into budget decision making. Unfortunately, policy makers don't respond to rational issues all the time; they are impelled by other non-technical factors in decision-making.

We have one of the most technically sophisticated budget systems in the world. Ironically, even as the Philippines has been improving not only its budget technology but also other aspects of fiscal administration, formidable problems in the economy have been piling up. The very real problems of a developing country like the Philippines on the political, economic and administrative fronts have made it difficult to implement sophisticated technology. The diligent efforts that went into the institutionalization of these various approaches cannot be minimized. Still the search for an effective budgeting approach continues.

ENDNOTES

[1]See Allen Schick's "The Road to PPBS: The Stages of Budget Reform," as reprinted from the Public Administration Review Vol. 26, No. 4 (December 1966), pp. 243-258 in Planning-Programming- Budgeting: A Systems Approach to Management, Edited by Fremont J. Lyden and Ernest B. Miller, 2nd Edition (Rand McNally College Publishing Company: Chicago, 1972), pp. 14-40.

[2]Schick, *ibid.*, p. 31.

[3]Schick, *ibid.*, p. 38.

[4]Aaron Wildavsky, The Politics of the Budget Process, Boston: Little Brown and Company, Second Edition, 1974.

[5]Robert T. Golembiewski, Public Budgeting and Finance: Reading Theory and Practice, Illinois, F.E. Peacock Publishers, Inc., 1975.

[6]Allen Schick, Budget Innovation in the States, The Brookings Institution, Washington, D.C., 1971, pp. 22-23.

[7]Allen Schick, *ibid.*, p. 30.

[8]Quoted by Angel Q. Yoingco in his article, Performance Budgeting for the Philippine Government," which is largely the basis of Dr. Jose D. Soberano's Chapter 11, "Performance Budgeting," of his book co-authored with H. Odell Waldby, Philippine Public Fiscal Administration: Readings and Documents (Manila: Graduate School of Public Administration, University of the Philippines, 1966), p. 386.

[9]Jesse Burkehead, Government Budgeting, (New York: John Wiley and Sons, Inc., 1956) pp. 120-128.

[10]Angel Q. Yoingco, *op. cit.*, p. 387.

[11]See: Allen Schick's account in Budget Innovation in the States, pp. 8; 66-69; 77-79; 82-83.

[12]Angel Q. Yoingco and Avelino B. Lim, "The Philippine Budget System", Chapter 15 of Fiscal Systems and Practices in Asian Countries by Angel Q. Yoingco and Ruben F. Trinidad (New York: Frederick A. Praeger) p. 358.

[13]Yoingco and Lim, *ibid.*, p. 385.

[14]Leonor Magtolis Briones, "Notes on American Influence in Selected Fiscal Management Practices in the Philippines," in Public Finance Readings and Cases, Vol. II, (Quezon City: COA State Accounting and Auditing Center), pp. 33.

[15]Eduardo Z. Romualdez, Sr., Angel Q. Yoingco, and Antonio O. Casem, Jr. Philippine Public Finance, (Manila: GCIC Enterprises and Co., Inc. 1973), p. 124.

[16]See Leonor M. Briones, *op. cit.*, p. 6-11.

[17]Allen Schick, "The Road to PPBS: The Stages of Budget Reform," p. 19.

[18]Jack Rabin, in Public Budgeting and Finance: Reading in theory and practice, Robert T. Golembiewski, Editor.

[19]Daving J. Ott and Attiat F. Ott, "The Budget Process in Public Budgeting and Finance.

[20]Arthur Smithies, "The Budgetary Process in the United States (McGraw-Hill Book Company, 1955).

[21]This summary is based mostly on the writings of Schick, Smithies, Ott and Ottiat and Charles Schultze.

[22]Allen Schick, Budget Innovation in the States, p. 115.

[23]Leonor M. Briones, *op. cit.*, pp. 12-14.

[24]See: Aaron B. Wildavsky's, The Politics of the Budgetary Process.

[25]Harry P. Hatry and John F. Cotton, in Public Budgeting and Finance...

[26]As quoted by Michael J. White, "The Impact of Management Service on Political Decision-Making," in Planning-Programming- Budgeting: A Systems Approach to Management, p. 397.

[27]Otto Eckstein.

[28]James S. Dyer, "The Use of PPBS in Higher Education," in Planning-Programming-Budgeting: A Systems Approach to Management...), pp. 372-373.

[29]Corazon Pe Benito-Claudio, "A New Budgetary Approach," in Papers on Long-Term and Zero-Base Budgeting, presented at a Budget Commission Executive Forum, held on June 28, 1977 at the Philippine International Convention Center, (Published by the Budget Commission, Malacanang, Manila, 1977) p. 56.

[30]Corazon Pe Benito-Claudio, Zero-Base Budgeting in the Philippine Government, Occasional Papers (7) (Manila: Ministry of the Budget, 1977) p. 2. (Note: Ms Claudio was one of the first Budget Commission official sent to the U.S. to study ZBB as it applies to the Federal Government).

[31]Preciosa R. David, "Zero Base Budgeting in the Philippine Setting," a paper prepared and presented in her capacity as officer-in-charge of the Training and Information Service, Ministry of the Budget (in mimeo form, 1979), p. 6.

[32]For further elaboration/illustration of these terms, refer to Claudio's Zero Base Budgeting in Philippine Government and David's Zero Base Budgeting in the Philippine Setting.

[33]Corazon P. Claudio, Zero Base Budgeting in Philippine Government, pp. 9-22.

[34]Corazon P. Claudio, "A New Budgeting Approach," Papers on Long- Term and Zero Base Budgeting, p. 58.

[35]For elaborate answers, see: Corazon P. Claudio's Zero Base Budgeting in Philippine Government, pp. 12-24.

[36]James P. Pffiner, "Budgeting and the People's Reform," in Public Administration Review (March-April 1980)

[37]Aaron B. Wildavsky, The Politics of the Budget Process, pp. 197.

[38]As quoted by Corazon P. Claudio, "A New Budgetary Approach," p. 61.

[39]Leonor M. Briones, *op. cit.*, p. 15.

[40]Corazon P. Claudio, "A New Budgeting Approach," p. 60.

[41]James P. Pfiffner, *op. cit.*, p. 197.

[42]Jaime C. Laya, in a lecture on "Expenditure Policy" delivered at a seminar on Public Finance conducted by the State Accounting and Auditing Center, Commission on Audit on October 20, 1980 in Quezon City.

[43]Armand V. Fabella, extemporaneous speech at the Financial and Management Chief's meeting on April 29, 1977 which was later published as part of Papers on Long-Term and Zero-Base Budgeting, p. 51.

[44]Manuel S. Alba, in an open forum after delivering a lecture on "Integrated Development Approach," Symposium on Budget Management, (Manila: Ministry of the Budget, 1978), p. 40.

[45]Armand V. Fabella, *op. cit.*, p. 57.

[46]Corazon P. Claudio, *op. cit.*, p. 57.

[47]Armand V. Fabella, *op. cit.*, p. 52.

CHAPTER 12

ORGANIZATION FOR PHILIPPINE BUDGETING

I. INTRODUCTION

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A. Budget Coordination

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ORGANIZATION FOR PHILIPPINE BUDGETING

I. INTRODUCTION

In most developing countries the attainment of development goals and objectives and the implementation of government programs and projects are greatly influenced by the availability of human and non-human resources. But since the national development task is gigantic and resources are scarce and limited, there is a serious need for an effective allocation of these resources in order that these will be more responsive to developmental needs.

It should be borne in mind however that efficiency, economy and effectiveness in government operations are further dependent on development-oriented concepts and approaches related to the strengthening of the planning system, improvement of the civil service, administrative decentralization and others. These are factors which need to be translated into structural changes and new patterns of authority and administrative relationships. In short, a new organization for development.

Inevitably, a vital area in any government organization relates to the allocation of public resources. Budgeting is one of the major processes by which the use of human and material resources of the government is planned and controlled.[1] In the 70's, to effect structural and administrative reforms for development, the Integrated Reorganization Plan, approved through the promulgation of P.D. No. 1, provided the first organizational base for Philippine development budgeting. The Plan stated:

> *It was declared a policy that the national budget be formulated to accelerate social and economic development and that government budgeting be oriented towards the evaluation of actual performance in terms of explicit objectives and expected results to ensure that funds are utilized and operations are conducted effectively, efficiently and economically.*[2]

Towards that end, certain structural changes and innovations related to government budgeting were introduced. These were geared towards achieving maximization of the utility of public resources, at the same time enabling integrated and coordinated working relationships among fiscal, planning and budgeting agencies in the government in order to pursue common development objectives.

II. THE DEVELOPMENT BUDGET COORDINATION COMMITTEE

At the helm of coordinating the various structures/agencies involved in national budgeting is the Development Budget Coordination Committee (DBCC). The Committee, composed of the Budget Secretary as Chairman and the NEDA Director-General, the Finance Secretary and the Central Bank Governor as members provide the linkages between planning and budgeting in the Philippines.

The following is a synoptic account of the DBCC's history:[3]

Through Administrative Order No. 213 dated March 31, 1970, President Marcos created a Study Committee to investigate budgetary issues as they relate to national plans and programs. In capsule, the Study Committee was tasked to:

a) Establish a national allocation of resources in accordance with national priorities, thus resolving the conflict between plans, programs and budget;

b) Formulate procedures and policies as well as a reporting system that will coordinate planning, programming and budgetary functions; and

c) Recommend necessary legislation and other measures related to the above.

One major recommendation of the Study Committee is the creation of a President Development Budget Coordination Committee (PDBC) to ensure consistency as to the ends/objectives between the budget and national long-term and medium-term development plans. Therefore, President Marcos issued on May 4, 1970, Executive Order No. 232 creating PDBC, composed of the Budget Commissioner as Chairman, and the Director-General of the Presidential Economic Staff (PES), the Chairman of the National Economic Council (NEC), the Secretary of Finance and the Governor of Central Bank as members. The participation of other fiscal planning agencies in the PDBC was also encouraged to involve them fully in development planning/budgeting and decision-making.

With the advent of Martial Law and the implementation of the Integrated Reorganization Plan, the PDBC was retained as a permanent agency attached to the National Economic and Development Authority (NEDA) and renamed Development Budget Coordination Committee or DBCC. The abolition of the PES and the restructuring of NEC to NEDA reduced membership in the DBCC to four.

The major functions of the DBCC include:

1) Establishment of the level of annual government expenditure program and ceilings of government spending in economic and social development, national defense, general government and debt services;

2) Determination of the proper allocation of expenditures for each development activity between current operating expenditures (COE) and capital outlays (CO), allotting not more than 85 percent of total government expenditure to COE and at least 15 percent to capital outlays;

3) Allocation of the amount set for capital outlays under each development activity for the various capital infrastructure projects;

4) Assessment of the reliability of revenue estimates;

5) Recommendation of appropriate tax or other revenue measures and extent and type of borrowings;

6) Conduct of periodic review and general examination of costs, accomplishment, and performance standards applied in undertaking development projects, including the review of a mid-year and annual budgetary performance;

7) Approval and recommendation to the President of general policy guidelines in the preparation of the national budget; and

8) Approval and confirmation of various requests of the Ministry of Finance for bond flotation.

The DBCC is assisted by an Executive Technical Board (ETB) composed of ten representatives from participating agencies to support the DBCC in carrying out its functions. The ETB has three (3) working units which provide staff and administrative support. These are: 1) the Economic Analysis and Fiscal Planning Staff, 2) the Government Finance Statistics Staff and, 3) the Budgetary Reforms Staff. The nucleus of the DBCC's administrative support staff (DBCC Secretariat) is the Fiscal Planning Service of the Department of Budget and Management under Exec. Order No. 232. The Secretariat is composed of a chairman and five members.

Members of the DBCC technical Staff may at the same time serve as members in the Executive Technical Board. Essentially, the technical staff, composed of several consultants, mostly from DBM, has as its main tasks

research, analysis and formulation of the government's levels of fiscal operations. On the other hand, the main functions of the Technical Board is to review the findings of the Technical Staff and, based on its findings, make recommendations to the DBCC Proper. It is significant to note that presently, the Commission on Audit serves as a member of the Executive Technical Board even if it is not within the formal, legitimate DBCC structure as provided for in the Integrated Reorganization Plan.

How does the DBCC operate? Briefly the flow of DBCC activities is summarized as follows:[4] The DBCC operations are guided by its own annual work program and administrative procedures. The Committee Proper convenes at least five times a year, depending on the need for and urgency of meetings. Budgetary guidelines and policies, government fiscal operations, proposals and various matters having budgetary implications are discussed, revised or approved during these meetings. The members of the Executive Technical Board are usually present to clarify or justify the agenda.

The Board meets at least once a month to review or revise proposed policy guidelines, budgetary priorities, budgetary levels, allowable financial gap and borrowings. Each of the work units meets at least twice a month to evaluate projects being undertaken, or deliberate on the preparation of information required by the Committee or its Technical Board.

The administrative staff coordinates and monitors work in addition to its main functions of providing staff and administrative support for all DBCC meetings and activities. Its work includes writing and editing of reports, preparation of statements and tables, including collection, compilation and reproduction of materials required by the DBCC.

Budget Coordination. It has been stressed time and again that the areas that are affected by government budgeting include growth rate in economic activity, domestic credit expansion, price levels and the international balance of payments position of the country. The often conflicting requirements of these different objectives are sought to be reconciled in close coordination among the planning, fiscal and monetary agencies of government, specially the NEDA, the coordinator of development plan implementation; the Ministry of Finance, as the revenue producing and debt regulating agency of government; the Central Bank of the Philippines as the agency responsible for the determination of the domestic and international value of the peso; and the Department of Budget and Mangement.[5]

Formal coordination and linkages of the above-mentioned agencies are performed through the Development Budget Coordination Committee, one of the sub-committees of NEDA. The relationships among the agencies involved in the DBCC is explained by then Budget Minister Jaime C. Laya in this sense: "Our work is closely intertwined because, first of all, the national

government must work on just one set of priorities, one set of objectives, one strategy, one set of plans, one set of policies. This is what is embodied in the National Economic Plan. We must also work with the Department of Finance because the way the fiscal structure of government is organized, the Department, you might say, is the husband of the family, and the budget people, the wife; husband in the sense that the Department raises the money, and wife, in our case, because we spend the money. We also work closely with the Central Bank because its responsibilities include domestic prices/credits and the international balance of payments; and the budget is one of the major factors that affect these two responsibilities of the Central Bank."[6]

Underscoring the need for unity of viewpoint, P.D. No. 1177 provides in Section 4 that budgetary priorities shall be those specified in the National Development Plan and agency budget proposals shall explicitly state linkages with approved agency plans.

III. THE DEPARTMENT OF BUDGET AND MANAGEMENT (DBM)

A. *Historical Background*

The Integrated Reorganization Plan highlighted the role of the Office of Budget and Management, originally Budget Commission, as the Philippine President's main staff arm in budgetary and management improvement. The evolution of this 46- year old central budget agency is noteworthy, considering the DBM's pivotal role in the allocation of government's limited resources and influence in determining national development priorities.

The history of the Department of Budget and Management (DBM) reflected the development of the country's budgetary system. This began upon the enactment of the Philippine Bill of 1902, assigning to the executive branch - the American Governor General through the Executive Secretary - the responsibility of preparing an annual estimate of expenditures. The statement of receipts and expenditures, however, were merely compiled and collated by the Executive Secretary. The power of revision and coordination was left to the Legislature, the American-dominated Philippine Commission.

The Jones Law of 1916, restored executive dominance in the determination of the budget. The law provided for the establishment of an executive budgetary process, entrusting the annual budget preparation to the executive branch. A Budget Office was created within the Department of Finance to prepare the annual estimates of expenditures. The Undersecretary of Finance, who headed the Budget Office, reviewed the estimates submitted

by the various departments and compared them with the estimated receipts of the government for the fiscal year.

Even if an executive budgetary system was established by the Jones Law, the Council of State, an administrative-legislative board composed of the presiding officers of both chambers of the lawmaking bodies and the majority floor leaders of both houses, actually undertook the final budgeting.[7] The budget agreed upon by the Governor General and the Council of State was binding on the Philippine legislative.[8]

The establishment of the Commonwealth regime gave way to the start of the development of a unified, centralized budgetary system. The 1935 Philippine Constitution mandated the President to submit "within 15 days of the opening of each regular session of Congress, a budget of receipts and expenditures which shall be the basis of the General Appropriations Bill,"[9]

In order to carry out effectively the provision of the 1935 Constitution, President Manuel L. Quezon, upon his assumption of office, recommended to the National Assembly the urgent need to revamp the government machinery. A Government Survey Board undertook a thorough study on the needed changes in the government structure. One of the significant recommendations of this Board was the creation of a Budget Commission to assist the President of his constitutional responsibility; that is, the preparation of annual budget of receipts and expenditures for submission to Congress. In response to the Board's recommendation, President Quezon issued Executive Order No. 25 on April 25, 1936, creating the Budget Commission within the Office of the President, and abolishing the old Budget Office which was under the Department of Finance. On September 30, 1936, the National Assembly ratified the creation of the Budget Commission. This set-up gave the President greater control in the budgetary process.[10]

The Budget Commission then was composed of the Director of the Budget Office (New Office) as Executive Director and Chairman, and the Director of Civil Service and the Auditor General as members. The Commission's major functions originally were: 1) Budgeting - to investigate, revise, examine, assemble, coordinate and reduce or increase the estimates of departments and agencies of governments; 2) Accounting - to determine the efficient and effective utilization of authorized expenditures (a function which was later transferred to the General Auditing Office); and 3) Management Organization - to study the departments and agencies of government as to their organization activities and operation and to recommend strategies for introducing efficiency and economy in the office (a function which is likewise presently undertaken by the present Commission on Audit).

B. *Significant Budget Legislations*

The triumvirate undertook its functions through the four divisions of the Budget Office: Budget Division, Expense Control Division, Service Inspection Division, and Administrative Division. The body was active during the early stage of the Commission, deciding policies on budget formulation and control. After sometime however the triumvirate hardly met, apparently because of the cumbersome set-up, thereby leaving most of the decision-making to the Commission Executive Director and Chairman.

Nevertheless, the Budget Commission was instrumental in the passage of the First Budget Act (Commonwealth Act No. 246) on December 17, 1937, under the term of Serafin Marabut, the first Budget Commissioner. This Budget Act prescribed the form of the budget and set the limits for authorized appropriations. It adopted the line-item budgeting where appropriations for all positions in the government service as well as for all furniture, equipment, and sundry expenses were itemized.

After Serafin Marabut whose term was from 1936-1941, the terms of the succeeding Commissioners, Pio Pedrosa (1941-1942) and Teofilo Sison (1942-1944) were relatively short mainly because of instability of the times brought about by the war. After World War II, however, Ismael Mathay, Sr. was installed as Commissioner, (1945-1946), followed by Pedrosa again (1946-1948), Pio Joven (1949-1953), and Dominador Aytona (1954-1960) who is best remembered for the passage of the Revised Budget Act (Republic Act 992) on June 4, 1954.

The Revised Budget Act changed the form of the budget from the line-item to the performance budget which introduced the "budgetary concept of government based on functions, activities and projects in terms of expected results."[11] The act also mandated that except in times of national emergency, the proposed expenditures should not exceed anticipated budget receipts and that actual expenses for current operations should not exceed annual receipts.

The Revised Budget Act likewise authorized the establishment of the Budget commission as an office under the executive control and supervision of the president. The triumviral office of the Budget Director, Auditor General and Director of Civil Service was abolished, and the Office of the Commissioner of the Budget and the Deputy Commissioner were created. The Budget Commission then took over the function of preparing the annual budget under such policies as might be adopted by the President, as well as the responsibility for the overall analysis, coordination and control of fiscal matters and management practices for the entire government. The Act enhanced the Commissioner's role as the fiscal arm of the President.

After Aytona, the next budget Commissioner was Faustino Sychangco who served the longest term (1960-1975) of 15 years, until 1975 when Jaime C. Laya took over as Commissioner in an acting capacity. Under Laya's administration (which lasted until 1980), the Budget Commission in particular and the government budgetary system in general underwent wide-ranging structural, legislative and substantive changes. Next to Laya, Manuel S. Alba headed the Ministry. Budget Secretary Guillermo Carague assumed the position during the administration of President Corazon C. Aquino.

C. *The Present Department of the Budget and Management*

The Budget Commission grew tremendously since 1936. Pursuant to Presidential Decree No. 1 and the Integrated Reorganization Plan, the mission, goals and functions of the Budget Commission were laid down explicitly. These were later amplified and/or modified in response to changing conditions and demands of fiscal administration under P.D. No. 899 issued on March 30, 1976. P.D. No. 899 reorganized the pre-martial law set-up of the Budget Commission.

What may be considered the most significant event in the history of the Budget Commission was its elevation into a Ministry by virtue of Presidential Decree No. 1405, giving its head the rank and qualification of a Minister and a member of the Cabinet.[12] Moreover, the Budget Ministry automatically became the Batasang Pambansa's Appropriation Committee while the Ministry of the Budget became the Committee's technical staff.[13]

Through Executive Order No. 708, the Office of the President underwent a reorganization effective July 1, 1981.[14] In line with the reorganization, the then Ministry of the Budget was renamed Office of Budget and Management. While the title of its head was changed to Director-General, the incumbent head enjoyed the rank of a Minister and was addressed then as Minister of the Budget. His two deputies were addressed individually as Deputy Minister.

Under the Aquino administration, which adopted the present presidential form of government, the Ministry of Budget and Management became a Department with a Cabinet-level Secretary. Like all secretaries the Budget Secretary has to undergo the difficult process of confirmation by the Commission of Appointment.

1. **The Mission of the DBM**

As central budget agency of the government, the Department of Budget and Management (DBM) assists the President in preparation, execution and control of the national budget. In the performance of these functions, DBM

"provides the necessary support to the government agencies in bringing better service to the people."[15]

The Administrative Code of 1987 sets up the twin mandates of the DBM. These are the responsibilities for (1) formulation and implementation of the national budget with the goal of attaining national socioeconomic plans and objectives, and (2) efficient and sound utilization of government funds and revenues to effectively achieve national development objectives.[16] For these purposes, DBM is charged with giving assistance to the President in

> *"the preparation of a national resources and expenditures budget, preparation, execution and control of the National Budget, preparation and maintenance of accounting systems essential to the budgetary process, achievement of more economy and efficiency in the management of government operations, administration of compensation and position classification systems, assessment of organizational effectiveness and review and evaluation of legislative proposals having budgetary or organizational implications."*[17]

To enhance DBM's performance in the foregoing functions, P.D. No. 1177 or the Budget Reform Decree (issued on July 30, 1972) institutionalized various budgetary innovations. The national budget was formally made a major instrument for national development. Subsequently, the department assumed the task of implementing necessary budgetary reforms to improve the budget process covering preparation, legislation, execution and accountability.

2. DBM Organizational Structure

After undergoing a number of functional and organizational changes, the DBM's organizational structure now reflects one that is dynamically flexible and responsive to the challenges and demands of development.

The herculean tasks of the budgeting is placed on the shoulders of the Budget Secretary, who is assisted by five Undersecretaries and five Assistant Secretaries.[18] The Undersecretaries "exercise supervision over the offices, services, operating units and individuals under their authority and responsibility."[19] The Assistant Secretaries assist the Secretary and the Undersecretaries formulate, determine and implement budget and management laws, policies, plans, programs and projects, and oversee the day-to-day administration of the constituent units of the DBM.[20]

The three major Department Services are the Management Services Office; the Legislative, Administrative and Procurement Services Office; and the Financial and Computer Services. Each Department Service is composed of bureaus and offices.

a. The Management Services Office[21] is composed of the following bureaus:

i. Systems and Procedures Bureau. This Bureau reviews and designs management reporting systems, reviews and evaluates the applicability and economics of computerization, purchasing/inventory systems, formulates measures on internal control to ensure accuracy, integrity and reliability of records systems, and develops a system of controls for capital operational and cash budgeting;

ii. Organizational and Productivity Improvement Bureau. It develops performance evaluation, conducts studies on work simplification and methods of improvement, reviews equipment procurement programs of agencies, and prepares operations manuals and conducts continuing studies on organization changes of government agencies;

iii. Compensation and Position Classification Bureau. It classifies positions and determines appropriate salaries for specific position classes and reviews compensation benefits programs of agencies and designs job evaluation programs.

b.The Legislative, Administrative and Procurement Services Office[22] is composed of:

i. Legislative Services. It provides legal advice and service to the Department Officers and Employees, reviews legislative proposals and provides clarificatory opinions on budget laws;

ii. Administrative Services. It provides services relative to personnel, records management, allocation of property and supplies, and performs security and custodial functions;

iii. Procurement Services. It implements integrated programs for the procurement of supplies and materials for DBM.

c.The Financial and Computer Services[23] consists of the Financial Services which provides services relative to cash management, budgetary and financial matters, and the Data Processing Service which provides computer services, prepares and generates management reports, maintains and operates computer-based monitoring systems.

d. Other major bureaus and offices are:

Budget Operations Office.[24] It reviews and analyzes the work and financial flows, the budgetary proposals of national and local government agencies and corporations, check each agency's compliance with the budgetary policies and project priorities, determines the budgetary implications of foreign assisted projects from the time of project design to the negotiation for financial assistance, prepares recommendations for fund releases,formulates and implements fiscal policies and plans for budget preparation and control, and conducts studies on economic trends and factors affecting government revenues, expenditures and borrowings. It is composed of the following bureaus:

1.1 National Government Budget Bureaus A and B. They evaluate and review the budgetary proposals, work and financial flows of the national government and ensure compliance with budgetary policies and project priorities of the bureaus assigned to each group;

1.2 Local Government Budget Bureau. It recommends and effects release of National Assistance for Local government (NALGU) funds and those for autonomous regions based on approved work and financial plans as limited by the Budget Secretary;

1.3 Government Corporation Budget Bureau. It evaluates and analyzes the budgetary proposals, plans and financial flows of government corporations and agencies and ensure compliance with budgetary policies and project priorities;

1.4 Budget Planning Bureau. It assists the budget Secretary in the preparation and management of fiscal policies and plans for budget coordination, conducts studies on economic trends and factors affecting government revenues, expenditures and borrowings, and collaborates with the Office of the President, Department of Finance, Central Bank, National Economic and Development Authority, and other agencies in the formulation of financial plans;

1.5 Foreign Assisted Projects Bureau. It reviews and evaluates foreign assisted projects to determine the annual funding requirements of certain projects identified by implementing agencies and supported by foreign funding; assists the Budget Secretary in determining the budgetary implications of foreign assisted projects from time of project design to negotiations for financial assistance; ensures the concurrence of the Budget Secretary on all loan agreements; evaluates the work-financial plan of projects chargeable against the foreign assistance

Projects (FAPS) support fund; and recommends and effects the releases from such fund based on the approved work financial plans as may be directed by the Secretary.

ii. National Accounting and Financial Office.[25] It takes charge of the maintenance of the data bank of financial information and provides necessary data required by the President, fiscal agencies and international financial institutions, analyzes and evaluate the accounts and overall financial performance of the government, and supervises the management of the accounts of government agencies and instrumentalities. It is composed of the following bureaus:

2.1 National Government Account and Finance Bureau;
2.2 Local government Accounting and Finance Bureau;
2.3 Government Corporate Accounting and Finance Bureau.

iii. Regional Offices. It implements the policies, programs, standards and guidelines on budget administration and management in the region.[26]

D. *Linkages of the DBM with other Fiscal Agencies*

The linkage of the Office of Budget and Management with other fiscal agencies such as the Department of Finance, the NEDA, the Central Bank and the COA is described by one of its Directors as consisting of two levels, one visual and the other, non-visual.[27]

The visual linkage (more of the organization/physical overlink or underlink) requires close coordination on a one-to-one personal basis. Hence, on an agency basis, personnel of the OBM have their counterparts in the Financial and Management Services and Planning Services or their equivalents in other ministries and offices. A typical Financial and Management, personnel of which are in close coordination with the appropriate DBM offices with regard to their specific parallel functions.

The non-visual linkage, on the other hand, comes in the form of papers, issuances, promulgations, memoranda and circulars which in some instances are prepared jointly by the DBM with appropriate Offices called for in the issuance, say COA, BIR, Bureau of Customs, Treasury or CB especially when they affect and/or pertain to the national budget. The DBM can

also issue a joint circular with a non-fiscal agency, like the Civil Service Commission, on matters with budgetary implications, such as the granting of merit increases or scholarship programs.

In more specific terms, the kind of relationship that DBM has with other fiscal agencies is defined on the basis of the particular type of information or data inputs which DBM requires from these offices.[28]

The DBM has to work and coordinate with the Department of Finance because of the way the fiscal structure of the government is organized. The DOF particularly its two bureaus - the BIR and the Customs Bureau - raises the funds for government operations, and the OBM allocates and spends the money primarily, considering the matter of establishing priorities and in line with established priorities. In other words, the DBM requires from the BIR estimates of revenue as the DBM relies heavily on these data for purposes of budget preparation. Thus, the DBM cannot prepare the ceilings for the next calendar year without estimates of revenue. From the Bureau of the Treasury, the DBM generates data on public debt, loans and grant availment, and each position of the national government.

The DBM has to work very closely with the Central Bank because the national budget which is prepared, controlled and executed by the DBM is one of the major factors that affect two of the Central Bank's main responsibilities, namely: domestic prices/credits and the international balance of payments.[29] When the Treasury borrows from foreign countries/creditors, the loan affects the international balance of payments and when it borrows the loan affects the Central Bank, the loan affects the money supply, and prices increase.[30] In terms of the ceiling, the DBCC provides a format for closer working relationships.

From NEDA, the following information are secured by the DBM for DBCC data inputs: details of infrastructure program, prescribed policies in the medium - and long-term National Development Plan/Regional Development Plan.

The Commission on Audit (COA) has been assigned the function of issuing accounting regulations. The DBM, and the COA, together with the implementing agencies, work closely in getting and giving accounting data. The DBM gets information on physical performance, physical units of performance, information on the staffing, and corollary information, including work measurement units and other components of management information.[31] Budget division/units of agencies and the DBM decide the nature of information they require. The COA furnishes the necessary accounting data when needed.

IV. ISSUES AND PROBLEMS

If we gauge the present status of government budgeting on the DBM's organizational set-up and the coordinative mechanism adopted by the DBCC as discussed above, we might readily conclude that we have an ideal budgeting system. On top of this, we can even expect more structural revamps in the future to meet new changes and increasing requirements in budgetary policy and administration. All these are praiseworthy and welcome, but beyond structures and procedures lie problem areas awaiting scrutiny and remedy.[32]

First is the need to make the budget staff, both at the central staff (DBM) and operating agency levels, not only more proficient and up-to-date but more development-oriented. In budgeting as in other areas of administration. It is the staff that counts. The best organizational structures and procedures can be rendered meaningless or ineffective by incompetent, unimaginative staff. Corollary to this problem area is the need to overcome cynicism among operation managers who consider the budget as more than a tool for planning and controlling the use of resources for social and economic development.

It is also imperative that the budget staff not be motivated to minimize government expenditures within the constraints of current revenues. The emphasis must be shifted from fiscal control to management control, with greater attention to what the government does with the inputs rather than on the inputs themselves. Necessarily the budget staff must think of the total environment and the interrelationship of activities within an agency and among the agencies, and more importantly, between the government and the larger community.

Second, organization for development budgeting requires a closer collaboration between the Department of the Budget and Management and the operating departments and agencies. Such collaboration should be characterized by mutual trust and respect, by a common goal to effectively and efficiently manage the resources of government, and by a joint effort to stimulate and facilitate defined programs of socioeconomic development. As a rule, therefore, budget analysts must fully understand the substantive activities of the agencies assigned to them and be keenly aware of new developments as well as the intricacies, dynamics and nuances of management in such agencies.

Third, there is a need to upgrade the budgeting and management capability of administration and staff in the line departments and offices, including those in the regional and field offices. Budgeting is a basic function of management, planning being one of its essential functions. Poor Man-

agement of this functional area may lead to a pathetic situation in which the budgetary process becomes just a superficial ritual and in which an agency run in stiff competition with other agencies for an allocation of limited resources with the absence of well- defined program goals and objectives.

In addition to the above-mentioned issues and problems, we may also cite a corollary, significant factor that serves as an impediment to an effective organization for national development budgeting. This refers to a need for a shift in orientation among the national leadership/officials in general and the budget authorities in particular, from a limited, passive orientation to a more dynamic, responsive and comprehensive one. In other words, to be able to make the various organization for budgeting/fiscal resource allocation effective and efficacious, the officials and staff manning these organizations should first and foremost be development-oriented.

Another basic issue is the lack of an integrated monitoring system of fiscal agencies in the Philippines particularly in areas that influence or affect the national resource budget. It is true that quite often it has been emphasized that formal linkages and coordination of the fiscal agencies find their way through the DBCC. Sadly however, it is also a fact that in the field of public administration the word "coordination" has been too loosely used that very often it does not engender meaningful or substantive execution. It appears the coordination is to be accomplished. For coordination, too, can become a myth and a shibboleth and is still imponderable."[33] Without a well-defined coordinative mechanism for the budgetary/fiscal organization, it is difficult to conceive an integrated monitoring system that will enable identification of problem areas in budget or fiscal policy implementation, as well as the missing links in the concerned agencies - from the DBCC to the operating ministries and offices.

Finally, there are many difficulties involved in implementing the concept of national resource budgeting as mandated by P.D. 1177. The DBM has taken over the function of reviewing local government budgets and monitoring the budgets of public enterprise. Still, difficulties in integrating three different sets of budgetary information (national, local and corporate) persist. Certain public enterprises are not willing to divulge information on their budgets and financial operations even to the DBM. The sheer number and variety of local government budgets have also created problems of integration. It might therefore take time before this laudable concept can truly be operationalized.

ENDNOTES

[1]Abelardo G. Samonte, "Organization for Development Budgeting," in Symposium on Budget Management, (Malacanang, Manila: Ministry of the Budget, 1978), p. 92.

[2]Integrated Reorganization Plan Vol. 1 of The Reorganization of the Executive Branch of the Philippine Government, (Manila: Lawin Publishing House, Inc., 1973), p. 67.

[3]See Manuel A. Dia, "The Development Budget Coordination Committee (DBCC) in the Budget Process for Development," a term paper submitted in course Public Fiscal Administration, University of the Philippines, College of Public Administration, first semester 1976. (in mimeo form, as suggested reading in P.A. 231 course.)

[4]Elpidio A. Floresca, "The DBCC: Its role in National Progress," Philippine Budget Management, Vol. 1, No. 2, (June 1977), p. 28.

[5]Jaime C. Laya, Philippine Government Budgeting: Policy and Practice in the New Society, (Manila: Ministry of the Budget, 1979), pp. 17-18.

[6]Jaime C. Laya, "Budgetary Development Under the New Society," address delivered at the Symposium on Budget Management. April 25, 1978, Philippine International Convention Center, Manila and published in Symposium on Budget Management, (Malacanang, Manila: Ministry of the Budget, 1978), p. 2.

[7]The Ministry of the Budget, Malacanang, Manila, (1978), p. 36.

[8]*Ibid.*

[9]The Philippine Constitution of 1935, Article VI, Section 19 (1).

[10]Jaime C. Laya, Budgetary Innovations in the New Society, (Manila: Budget Commission, 1977), p. 1.

[11]"The Budget Commission: A Synoptic History," Philippine Budget Management, Vol. 1, (March 1977), pp. 7-9.

[12]Presidential Decree No. 1405, June 11, 1978.

[13]The Ministry of the Budget....., p. 48.

[14]Executive Order No. 708, July 1, 1981.

[15]The Ministry of the Budget, Office of the President, Malacanang, Manila, p. 1.

[16] Revised Administrative Code (RAC), Book IV, Title XVII, Section 2.

[17] RAC, Bk. IV, Title XVII, Sec. 3.

[18] RAC, Bk. IV, Title XVII, Secs. 5 and 6.

[19] *Ibid.*

[20] *Ibid.*

[21] RAC, Bk. IV, Title XVII, Sec. 7.

[22] RAC, Bk. IV, Title XVII, Sec. 8.

[23] RAC, Bk. IV, Title XVII, Sec. 9.

[24] RAC, Bk. IV, Title XVII, Sec. 10.

[25] RAC, Bk. IV, Title XVII, Sec. 11.

[26] RAC, Bk. IV, Title XVII, Sec. 12.

[27] Remarks of Director Vidal Pascasio, Budget Technical Service, during a panel discussion at the closing of the First Seminars on Public Finance conducted by the State Accounting and Auditing Center, Commission on Audit, Quezon City, July 1980.

[28] To a large extent this is a reiteration of the budgetary linkages earlier described under the sub-topic, Development Budget Coordination Committee (DBCC). However, what is emphasized here is the information requirements/data inputs which the OBM secures from other fiscal agencies.

[29] Jaime C. Laya, Budgetary, p. 2.

[30] *Ibid.*, p. 2.

[31] *Ibid.*, p. 8.

[32] Abelardo G. Samonte identified three problem areas/issues and offered corresponding solutions or prescriptions to erode such problems in his lecture, "Organizations for Development Budgeting," in Symposium on Budget Management, p. 95-96.

[33] Dennis A. Rondinelli, "The Bicol River Basin Development Program: Prototype of an Equitable Growth project," Reprinted from National Development, Vol. 20, No. 1, January-February 1979, p. 57.

CHAPTER 13

THE BUDGET PROCESS AND SIGNIFICANT BUDGETARY INNOVATIONS

I. INTRODUCTION

II. THE BUDGET CYCLE

- A. Budget Preparation
- B. Budget Authorization
  - 1. Congressional Deliberation
  - 2. Senate Deliberation
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- C. Budget Execution
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III. REFORMS AND INNOVATIONS IN THE BUDGET PROCESS

- A. Developments Under P.D. No. 1177
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IV. ISSUES AND PROBLEMS

- A. Budget Reforms and the Political System
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THE BUDGET PROCESS AND SIGNIFICANT BUDGETARY INNOVATIONS

I. INTRODUCTION

Constitutional and institutional arrangements, the size of the public sector, the thrusts of government programs and activities, and even international influences have a considerable impact on the organization of a government's budget system and the degree to which it exercises an influence on the total government process.

Whatever the form of government, budgeting always plays a central role in the public finance process. In the case of the Philippines, experiences from both modified parliamentary system of government and presidential form of government have not in any way diminished the importance of budgeting in government operations. Neither has the change in nomenclature (from a Ministry of the Budget to an Office of Budget and Management to a Department of Budget and Management) decreased its pivotal role in resource allocation. While government activities are accelerating due to development demands on government, the fact remains that resources are limited, and will always be limited. The compelling necessity to prioritize needs and allocate resources is an economic reality which can never be ignored, much less done away with.

In this chapter, the formal aspects of the budget process in the Philippines will be described in great detail. However, it should be borne in mind that the budget process is more than a system of procedures and structures. It is both a rigorous technical procedure and a controversial and dynamic political process as well. It is according to Wildavsky, "a process of translating behavioral actions of 'actors' performing their 'roles' in budgeting process." But far more than behavioral aspects, it reflects the close interplay of political and economic factors and pressures exerted by local and international interest groups.

II. THE BUDGET CYCLE[1]

The budget process consists of 4 phases: budget preparation, budget legislation or authorization, budget execution and budget accountability or review. This process is referred to as a cycle because after budget accountability or review of the current year ends, budget preparation for the following year's budget begins.[2] In practice, the budget process is a continuing cycle with certain stages in a given year's cycle overlapping with stages of another

cycle.[3] For instance, the final days of the budget accountability phase for the previous budget year is simultaneous with the budget execution phase of the current budget cycle, and the budget preparation phase of the budget cycle for the following year.

Essentially, the same budget process or cycle used during the Marcos years is followed, except for some improvements and innovations.[4]

A. *Budget Preparation*

Budget preparation phase covers the stages from determination of budgetary priorities to submission by the President of the Budget of the Expenditures and Sources of Funds (BESF) to Congress.

The first stage in budget preparation is the determination of budgetary priorities and activities which shall serve as one of the principal guides of government agencies in formulating their budget proposals. The guideline reflects the main thrusts of the national development plan and sets budget ceilings and restrictions in the light of available revenues and borrowing limits.[5] Nowhere in the budget process is the timely and accurate financial and monetary information more crucial than at this stage. Decisions made at this level have far reaching effects not only on the governmental system but on the entire economy as well. The architects of the budget who lay the basic foundations of the fiscal plan must start with reliable financial information which are collated from various sources. Developmental guidelines and projections are furnished by the NEDA; revenue estimates are worked out by the Secretary of Finance as inputted by its two major revenue-raising arms, the Bureau of Internal Revenue and the Bureau of Customs; expenditure data is supplied by the Department of the Budget and Management; and information on monetary developments is given by the Central Bank. Where up-to-date data is not available, heavy reliance is on estimates and projections. Thus, miscalculations and unwarranted assumptions have critical consequences.

Budget policy decisions are made at the level of the DBCC. For example, the size of the budget deficit as a per cent of the total budget and of the GNP are determined by the Committee. This is of course related to the borrowing policy of government. Allocations to the broad categories of government expenditures are also decided by the Committee. Thus, decisions about the allocations for economic development, social development, general government and debt services are made by the Committee. Here, the Committee grapples with the classic question raised by Pigou with regards to the budget: "What should be the basis of allocating X amount of pesos to activity Y and activity Z?" Or how do we make decisions between defense and poor relief?

It is also at the level of the DBCC where budget priorities are hammered into shape. Budgeting starts from the basic assumption that while wants are limitless, resources are scarce, hence, the need for prioritization. These are decisions which are made by the political leadership which gives the general guidelines and makes the final decision on what should be the budget thrust for a particular period. Since final accountability is with the political leadership, political preferences as to goods and services to be financed by the government are considered. Furthermore, planned political activities like referenda and elections and international commitments have to be considered because these have heavy cost implications.

Finally, exogenous factors have to be taken into consideration in fiscal planning. Like all developing countries, the Philippines is buffeted and pressured by international economic developments which are largely beyond control. Furthermore, budgetary guidelines set by international lending institutions as preconditions for loans have to be followed. For example, the guidelines suggested by the IMF on the size of the projected budget deficit for 1983 were adopted in consideration for the Philippine request for a standby arrangement with the International Monetary Fund.

To summarize, the substantive aspects of the budget are decided when the overall structure of the fiscal plan is worked out by the DBCC. Here, hard decisions on sectoral allocations have to be made. Even at the level of fiscal planning, the process is not only technical but political as well, in the sense that political preferences have to be considered and bargaining and compromise are involved in allocating scarce government resources among escalating demands and expectations. As one official puts it, tradeoffs of fiscal policy goals have to be made. Lastly, exogenous factors play an important role in determining the size of the budget deficit in times of economic difficulties.

The budget ceiling is fixed by the Executive Technical Board of the DBCC consistent with the macroeconomics targets embodied in the updated medium-term development plan.[6] Together with the budget ceiling, the deficit target and budget priorities are submitted for approval of the DBCC and subsequently of the Cabinet. This process illustrates the link between planning and budgeting at the policy level:

> *"The budget shall be formulated as an instrument for the attainment of national development goals and as a part of the planning-programming-budgeting continuum. Levels of revenue, expenditure and debt shall be established in relation to macroeconomic targets of growth, employment levels, and price level change, and shall be developed consistent with domestic and foreign debt and balance of payments objectives for the budget period. The aggregate magnitudes of the budget shall be deter-*

mined in close consultation among the planning and fiscal agencies of government. Budgetary priorities shall be those specified in the approved national plans, keeping in mind the capability and performance of the implementing agencies concerned. Agency budget proposals shall explicitly state linkage to approve agency plans."[7]

The next stage is *issuance of budget calls* directed to the heads of all departments, agencies, bureaus and offices of the national government. The budget calls spell out the macroeconomic parameters, broad policy guidelines, budget preparation schedule and the specific procedures to be followed by all agencies concerned. Issued in the form of a National Budget Circular, the budget call contains among others, the following:

(1) Outline of policies, guidelines and priority areas of government activity applicable to the budget year which begins a year and a month hence - as pronounced by the President. This comes in the form of a statement of the overriding theme for the budget year which will serve as the agency's main criterion in developing its plans and programs.

(2) Fiscal limits or expenditure levels and approximate rate of increase in government budget ceilings applicable to the budget year and appearing in the development plan, as updated in the long-term fiscal projections appearing in the latest Budget Message of the President. These serve as guides to agencies in determining the magnitude of their budgetary levels for the budget year.

(3) Coverage of budget estimates which specifies the activities to be integrated in the budget estimates.

(4) Government commitments, that is, those in support of treaty obligations, multi-year projects, counterpart to foreign-assisted projects among others.

(5) Information and requirements on regional budgeting, long-term budgeting, schedule of budget hearings, timetable and evaluation process, and instruction on the use and filling-up of various budget forms.

The issuance of the budget call prompts agency central offices to develop and issue guidelines (office circulars) to their respective regional offices.[8] These guidelines serve as one of two major directives to regional offices in the formulation of their respective budget proposals, the other being that issued by the regional development councils.

There are three kinds of budget calls: National Budget Call which covers all regular national government agencies, Regional Budget Call which signals the preparation and review of regional agency budget proposals, and Local Budget Call.[9] What has been referred to above is the national budget call.

At the regional level, the budget preparation phase begins with the issuance by regional development councils of guidelines on regional priorities and thrusts to all regional offices of government agencies. In accordance with these RDC guidelines and in conformity with their respective Central Office's guidelines, the regional offices prepare their budgets which are then submitted to the RDC. Budget hearings on the regional level of budget proposals of regional offices are conducted by the RDC. After which, RDC formulates its recommendations on the budget of regional offices to be forwarded to the respective Central Offices of regional offices and subsequently to the DBM.

At the national government level, RDC recommendations are consolidated by the different Central Offices in their agencywide budget proposals. The consolidated budget proposals of an agency is the principal subject in budget preparation. In compliance with the call for budget estimates, the agency head then mobilizes his budget and planning officers and their aides to start the preparation of their budget estimates. As was stated earlier, in addition to the Budget Circular issued by the DBM or the Budget Call, the usual practice is for the Department heads to issue, on the basis of the Budget Call, an internal office order specifying the budget year's theme thrusts, ceilings, and long-term plans which various units will take into account and link within the preparation of their unit budget proposals.

An agency's budget estimate consists of the following information:[10]

1. Objectives, functions, activities, programs and projects showing the general character and relative importance of the work to be accomplished or the services to be rendered, and the principal elements of cost involved;

2. Linkage of the work and financial proposals to approved development plans;

3. Estimated current operating expenditures and capital outlays, with comparative data for the preceding and current budget years;

4. Identification by region[11], pursuant to policies on the regionalization of government operations;

5. Financial resources, reflecting all revenues, proceeds of foreign and domestic borrowings, and other sources, particularly those which accrue to the General Funds;

6. Contingent liabilities, including national government guarantees of obligations of government-owned-and-controlled corporations and their subsidiaries;

7. Brief description of the major thrusts and priority programs and projects for the budget year, results expected for each budgetary program and project, the nature of work to be performed, estimated costs per unit of work measurement, including the various objects of expenditure for each project;

8. Organization charts and staffing patterns indicating the list of existing and proposed positions with corresponding salaries, and proposals for proposed classification and salary changes, duly supported by adequate justification.

In order to facilitate the preparation, consolidation and submission to DBM of a department-wide budget proposal, an internal Hearing and Review Committee is organized. Thus, internal budget hearings are scheduled for all units in the Central Office, regional offices and bureaus. No less than the Regional Bureau Director or Service Chief is required to defend his budget proposal before the hearing Committee.

The agency's consolidated budget estimates is then subjected to preliminary review by the DBM and technical budget hearings are conducted thereon with officials and technical staff of the agency concerned. This deliberative and consultative process does not only allow budget reviewers to obtain more detailed information useful in policy and technical review of the agency budget proposal but also provides agencies the opportunity to justify their proposals as well as present budget-related problems and issues.

The first level review of agency budget proposals with the DBM starts with the budget analysts who are assigned to analyze and evaluate proposals, find out the facts and come out with valid recommendations. In evaluating agency estimates, the analysts assigned bear in mind the following questions: Are the priorities or major activities of the agency in consonance with the national development goals as stipulated in the guidelines embodied in the Budget Call? Is the agency pursuing the same program or project structures as those approved by the DBM? Are the costs involved reasonable enough, evaluated against the expected output of economic and social benefits? Are the amounts being requested within the agency budget ceiling as determined by the DBM and approved by the DBCC?

The second level of evaluation comes through the technical budget which are viewed as dialogues between DBM and agency key officials after the agency proposals have been reviewed. The hearings provide opportunities for agency heads or representatives to explain and defend their budget estimates. On the other hand, budget hearings give DBM officials the chance to inquire and probe on agency operations, plans and programs, thus, giving them more inputs for decision-making and allocation of resources.

It is interesting to note that in most instances, the basis of discussion in the technical budget hearings is outside the formal content of the budget proposals. For example, the DBM team raises questions on duplication or overlapping functions of the agency under scrutiny with other agencies. The agency retorts that the activity spelled out in the proposal is a key function which is not without legal basis so it is but fitting that a Key Budgetary Inclusion (KBI) for such activity be included. Now, the question of another agency proposing or already doing the same activity is an issue beyond the control of the agency. For that matter, deliberations in the technical hearings end up without clear resolutions of issues as they are matters for consideration of top decision-makers.

Modifications and revisions of original budget proposals of an agency ensue from the technical budget hearings. During this period, the DBM, through the DBCC clears with the President major policy issues arising from the hearings. The President, having decided on major policy issues and overall budget allocations and policies gives his go signal to the DBM to compute total expenditure estimates and balance it with revenue estimates. The Executive Review Board Sessions are conducted.

Before the budget estimates go to the DBCC, they are still subjected to evaluation in Executive Review Board (ERB) sessions within the DBM. The ERB is made up of top officials of the DBM constituted to conduct comprehensive policy review of all agency and special purpose fund budget proposals.

After budget proposals are sent to DBCC for review, they are then submitted for deliberation and consideration by the Cabinet. On the basis of the foregoing the President then submits the national government budget to Congress. Among important documents submitted to Congress are the President's budget message, the Budget of Expenditures and Sources of Financing (BESF), the National Expenditure Program and the Regional Expenditure Program.

The President decides in what form he may present the budget to the Congress.[12] Ordinarily however, and as stated in the Revised Administrative Code, the budget presentation include:

1. *Budget Message.* It summarizes the budgetary thrust of the present administration (the executive branch) for the year in consonance with economic policies it has determined. It should also discuss the impact of such priorities on development goals, monetary and fiscal objectives, and generally on the implications of the revenue , expenditure and debt-proposals.[13]

2. *Summary of Financial Statements.* These include:[14]

a. Estimated expenditures and proposed appropriations necessary for the support of the Government for the ensuing fiscal year, including those financed from operating revenues and from domestic and foreign borrowings;

b. Estimated receipts during the ensuing fiscal year under laws existing at the time the budget is transmitted and under the revenue proposals, if any, forming part of the year's financing program;

c. Actual appropriations, expenditures, and receipts during the last completed fiscal year;

d. Estimated expenditures and receipts and actual or proposed appropriations during the fiscal year in progress;

e. Statements of the condition of the national Treasury at the end of the last completed fiscal year, the estimated condition of the Treasury at the end of the ensuing fiscal year, taking into account the adoption of financial proposals contained in the budget and showing, at the same time, the unencumbered and unobligated cash resources;

f. Essential facts regarding the bonded and other long-term obligations and indebtedness of the Government, both domestic and foreign, including identification of recipients of loan proceeds; and

g. Such other financial statements and data as are deemed necessary or desirable in order to make known in reasonable detail the financial condition of the government.

In sum, we may state the budget preparation phase as comprising the following major activities:[15]

1.1 Deficit level determination
1.2 Revenue projection
1.3 Budget level determination
1.4 Issuance of Budget Call

1.5 Budget hearings and consultations
1.6 DBCC review
1.7 Cabinet deliberation
1.8 Presidential Submission to Congress.

B. *Budget Authorization*

Budget legislation or authorization constitutes the second step of the budget process. It pertains to the legislative consideration and approval of the Appropriations Bill. After the President reviews the draft of the Appropriations Bill, he discusses it with the Cabinet, then submits it to Congress. In general, the legislature acts on the budget proposal of the President and formulates an Appropriations Act following the process established by the Constitution which specifies that no money may be paid from the Treasury except in accordance with an appropriation made by law.[16]

Appropriations are approved by the legislative body in the form of (a) a General Appropriations Law which covers most of the expenditure of government, (b) the various public work acts, (c) supplemental appropriation laws that are passed from time to time, and (d) certain automatic appropriations intended for specific purposes. As in other laws passed by the legislature, the Constitution provides for an approval of the Appropriations Act by the President.

The following are the details in Budget Legislation Stage:

1. **Congressional Deliberation of the Budget**

Submission of the budget to Congress within 30 days from the opening of every regular session is mandated by the Constitution.[17] The budget goes first to the lower house in compliance with the provision that appropriation and revenue bills shall originate exclusively with the House of Representatives.

The Budget of Expenditures and Sources of Financing (BESF) is received by the Secretary of the House of Representatives who will then report it to the House for the First Reading.[18] It is then assigned to the Committee on Appropriations.[19]

The BESF undergoes detailed study by the Appropriations Committee which it may refer to its subcommittees to conduct necessary public hearings on each government agency's budget proposal.[20] The Committee begins to call on the financial and economic authority of the Executive Branch for questioning on the overall budgetary situation.[21]

Having deliberated and discussed on the President's budget proposal and on the public hearings, the Appropriations Committee then submits a report to the House of Representatives recommending any of the following options:[22]

a. approval without amendments and it then becomes a bill;
b. approval with amendments and it also becomes a bill;
c. substitution with another bill; or,
d. disapproval.

When the bill is favorably reported out as in the first three cases, it will be scheduled for 2nd reading. However, if the Committee recommendation is unfavorable, the Bill will be "laid on the table".

It is in the second reading when the Bill is read in full, discussed in detail, subjected to deliberation, individual amendments and debate. It is then voted upon.

After the Bill is passed on Second Reading it is then considered for Third Reading. If the bill is passed on the Third Reading by a majority of the members of the House, it is transmitted to the Senate for concurrence.

2. Senate Deliberation

At the Senate the Bill is referred to the Finance Committee, the counterpart of the Committee on Appropriations of the House of Representatives.[23] Following similar processes in the Lower House, the recommendations of the Finance Committee is subject to deliberation by the Senate. In the same manner the Bill also undergoes three readings conducted on separate days.

Where, however, the Senate recommendations differs from those of the Lower House, the Bill is referred to the Conference Committee for further review and deliberation. Otherwise, a joint house deliberation of the Bill will be conducted.

The Conference Committee formulates recommendations which will be subject to joint deliberation by both Houses. It is composed of equal numbers of Senators and Representatives for the purpose of ironing out differences in the version so as to be able to pass a compromise version of the Bill.

Whenever the Bill is not favorably voted upon by both Houses it goes back to the Conference Committee until a compromise version is accepted.

Only the Bill which was passed in both Houses is submitted to the President.

In the extreme possibility that Congress fails to pass the Bill, the Constitution provides[24]

> *"If by the end of the fiscal year, the Congress shall have failed to pass the general appropriations bill for the ensuing year, the general appropriations law for the preceding year shall be deemed reenacted and shall in force and effect until the general appropriations bill is passed by Congress".*

3. Presidential Review and Veto

Like all bills passed by Congress, the BESF also undergoes presidential review pursuant to Section 27 Article VI of the Constitution. If it is approved by the President and he signs it, it becomes a law. However, he may choose not to act on it, in which case he is deemed to have approved it after the lapse of thirty days. Otherwise, the President within the thirty day period must veto the BESF or any items thereof by sending his veto message to the House of the Representatives. Congress may override the veto by garnering two-thirds (2/3) vote in each House, in which case it becomes law against the President's will.

A veto of an item is allowed only in the case of an appropriations bill. In all other cases the President must either veto the entire bill or give his imprimatur to it. While the item veto is allowed, veto of conditions is not.

In *Bolinao Electronics Corporation vs. Valencia* (11 SCRA 486), an item in a public works bill allocated funds for the support of television stations, with the condition that the financial assistance would not be available to places where commercial television stations exist. When the President concurred with the appropriation but turned down the condition, the Supreme Court held that the veto was ineffectual and his approval of the appropriations automatically carried with it the approval of its condition.

In the case of *Gonzales vs. Macaraig, Jr.*, (191 SCRA 452), Congress provided in the General Appropriations Act a provision which enjoined the President to augment budget items which were previously disallowed or decreased by the Legislature. The apparent purpose of the provision was to prevent the Chief Executive from subverting the legislative will.

Imagine a situation where the President proposes in the BESF to allocate P500,000.00 for the construction of Juan De la Cruz Elementary School and P100,000.00 for the repair and upkeep of Jose Bridge. Congress then disallows the school building construction and reduces the amount for

the bridge upkeep to P50,000.00. Without the proposed provision, the President may render ineffectual the Congressional will by going on with the school building construction and persist with the P100,000.00 repair of the bridge to be taken from savings. This will, in effect, modify provisions in PD 1177 allowing augmenting of expenditures in budget items. The provision was vetoed by the President and congressional leaders challenged the veto before the Supreme Court. The High Court upheld the presidential veto, among others, because the implied repeal of the law (PD 1177 and similar legislations) is not favored. More importantly, the provision

> *"... prohibit[s] the restoration or increase by augmentation of appropriations disapproved or reduced by Congress, [it] impair[s] the constitutional and statutory authority of the President and other key officials to augment any item or any appropriation from savings in the interest of expediency and efficiency.*[25]

C. *Budget Execution*

The third phase in the budget process is budget execution and it comprises the operational aspects of budgeting. It has the following components:[26]

(1) the submission and evaluation of agency annual work and financial plans and the subsequent issuances of quarterly advise of allotments and funding warrants;

(2) the continuing monitoring and review of the government's fiscal position; and

(3) cash management and monitoring and generally seeing to it that funds are available to support approved agency functions and projects.

Also included in this phase is the continuing performance of budget and management related activities such as review of agency organization structures and staffing, as well as continuing studies on position classification and compensation plans.[27]

Officially, the budget execution phase commences with the issuance by the DBM of a circular prescribing the preparation of the annual agency work and financial plans (WFPs)[28] shortly after the General Appropriations Act becomes a law. The agency annual work and financial plan is required for the following purposes:[29]

1. to promote efficiency in the programming and utilization of budgetary resources;

2. to adjust agency physical targets and the corresponding level of program implementation in accordance with the budgetary level approved under the General Appropriations Act; and,

3. to establish appropriate schedules for the release and utilization of funds in accordance with the agency work program.

A Work and Financial Plan embodies a work plan which indicates the various outputs to be accomplished every quarter, and a financial plan which indicates the monthly financial requirements determined on the basis of schedule of program implementation.[30]

Two major problems related to Work and Financial Plans are submission of inadequate work plan wherein agencies face difficulty in identifying and defining their physical targets, and inadequacy in financial planning.[31] The financial plan indicates the monthly funding of agency functions and projects, which in no case necessarily contemplates a situation where agencies simply spread the total budget for functions and projects equally over a 12-month period.[32] At present this is what is being done by all agencies.[33] While funds for personal services and regular MOOE may be equally allocated over 12 months, Capital Outlay funding requirements should be done in accordance with project implementation schedules.[34] To do this agency budget, officers coordinate with planning officers and project managers. Budgeting is not the monopoly of budget officers and accountants.[35]

There is a widespread complaint against the DBM for delays in the release of funds, a delay which the DBM attributes to poor programming on the part of the agencies rather than on processing time in the DBM. Since funding release schedules are based on the financial plan schedules submitted by agencies, faulty programming by agencies will inevitably result in a mismatch between project implementation and funds provision.[36]

In the release of funds step, a major reform was effected. This was the switch from the Cash Disbursement Ceiling (CDC) system to a Funding Warrant Scheme.[37] Under the latter scheme, the issuance by the DBM of the warrant triggers the debiting of the Bureau of the Treasury deposit with authorized commercial banks and the crediting of agency deposit accounts.[38]

As it presently stands, the disbursement procedure in the DBM comprises the several steps where DBM evaluates agency Work and Financial Plans and issues Advices of Allotments covering the 1st quarter requirements of the agency:[39]

1. The agency request is submitted to the National Government Budget Operations Bureau (NGBB).

2. If the request involves MOOe, NGBB evaluates.

3. If the request has a PS component, it is referred to CPCB for evaluation.

4. If the request involves capital outlay it is referred to OPIB for evaluation.

5. The recommendations of OPIB and CPCB are forwarded to NGBB for concurrence add computation of budgetary requirements.

6. NGBB prepares AA and other action documents.

7. AA and documents are forwarded to the Secretary or Undersecretary for approval.

8. Approved AA sent to agency.

A system closely associated with the budget releases system, the *Common Fund Scheme* ensures the availability of adequate cash at any given time in the agency's operations. It has the following salient features:[40]

1. Agencies pay all their obligations to disbursing officers from the Common Fund using allotment data in the AA as a control ceiling.

2. Unutilized allotments in any expenditure item under MOOE may be used to augment other items of the same allotment class, but not exceeding 25 percent of the augmented expenditure item without the approval of the DBM Secretary.

3. All unobligated allotments are reverted to the unappropriated surplus at the end of every fiscal year, the corresponding cash remains with the agency's servicing bank to back up the allotments to be released in the ensuing year.

4. The common funds are not applicable to trust liabilities which are authorized to be maintained under a separate account.

5. Terminal leave and retirement gratuity benefits of P100,000 and below per claimant shall be processed by the agency concerned. Those with greater than the said amount and separation pay benefits shall be evaluated and processed by the DBM.

6. Funding Warrants issued for the following shall form part of the agency's common fund:

   a. prior year's accounts payable;

   b. retirement gratuity and terminal leave benefits greater than P100,000;

   c. separation pay; and

   d. prior year's unbooked obligations.

To apply for the Common Fund the agency observe the following availment procedure:[41]

1. Monthly cash operating requirements are determined on the basis of the Work and Financial Plan.

2. The cash balance as of 31 May at the agency's servicing bank equivalent to 2 months operating requirements shall serve as the common fund.

3. All agencies shall pay the all obligations from the common fund using Allotment data as control ceiling.

4. The agencies shall submit a monthly status of common fund and a statement of changes in Accounts Payable.

5. Requests for replenishment of the Common Fund shall be made whenever the fund is at its critical level.

6. At the end of every Fiscal Year, all unobligated allotments shall revert to the unappropriated surplus of the General Fund. The corresponding cash, however, shall be remitted to the Bureau of the Treasury but shall be used to back up the agency allotments for the ensuing year.

The present disbursement scheme is an improvement of the previous disbursement scheme in that:[42]

a. With this scheme, agencies will not be able to disburse in excess of authorized ceilings since disbursements are automatically limited to the balance of deposit accounts.

b. Also, a faster reconciliation of check issuances against disbursement can be done ensuring stronger accounting control.

A major aspect of budget execution is Cash Management. It involves monitoring and control of the level of cash disbursement and balances to prevent undesirable levels of cash floats, etc.[43] This is because the budget execution phase includes the carrying out of other activities that have implications on the efficiency of resource allocation and utilization such as continuing assessment of the government's organization and staffing systems as well as compensation plans.[44]

D. *Budget Accountability and Review*

The last phase in the budget process involves submission of accountability reports to fiscal agencies and to Congress. This is preparation of financial and physical reports of operations which basically provides information on the actual physical accomplishment of agencies in relation to actual expenses accrued.[45] There are also Performance Reviews and Audits. Auditing is the detailed examination of the books of accounts to ensure that all expenses have been disbursed in accordance with accounting regulations and purpose for which the funds have been authorized.[46]

III. REFORMS AND INNOVATIONS IN THE BUDGET PROCESS

A. *Developments Under P.D. No. 1177*

According to former Budget Minister Laya, budgetary innovations in the New Society and the New Republic started with the Constitution of 1973. Recognizing the deficiencies of the old budget process, the delegates to the Constitutional Convention formulated provisions which would remove the bases of the abuses that plagued the pre-martial law government.[47] They recognized those sources of abuses and malpractices of old and proceeded to evolve provisions which would prevent these practices.

The provisions in the 1973 Constitution which changed the philosophy and structure of the old budget process guided the enactment of P.D. No. 1177 on July 30, 1972. This decree institutionalized the budget reforms initiated under the New Society and which continue to apply in the New Republic.

The introductory portions of the Budget Reform Decree or P.D. 1177 outline the major thrusts of the budgetary reforms. Section 3 summarizes these thrusts as follows: "A stronger linkage in the planning, programming and budgeting sequence, the close operating relationship between budgeting and internal agency management, a regionalized budget that is supportive of a region based government structure, the recognition that the

national budget is only part of the integrated whole of a total national resource budget, and the need to prepare annual budgets as one step in implementing the national long-term plan and long-term budget program."

The reforms and innovations in the Philippine budget system may be specifically viewed in terms of the changes in each of the stages compromising the budget cycle, although some may also mesh in one or all of the budget stages.

1. **Budget Preparation Phase**

a. The shift from fiscal year to calendar year to facilitate social and economic accounting and to harmonize the planning and budget cycles with those of government corporations and the private sectors.

b. Simplification of budget documents for laymen, researchers and even government officials.

c. Institutionalization of the regional budgeting system by reorganizing regional offices as the basic budgeting unit.

d. Increased attention given to foreign assisted projects.

e. The need for some organizational changes and strengthening of the role of coordinating bodies.

f. The development of a national resource budget.

2. **Budget Authorization Phase**

a. The policy provision in P.D. 1177 specifies that the Legislature shall focus on budgetary policy, levels, thrusts and strategies while details of agency expenditure shall be the proper concern of the executive branch. This policy focuses on the concept of performance budget wherein greater emphasis is placed on projected results and not on detailed items of expenditures.

b. A provision in P.D. 1177 states that the General Appropriations Act shall not contain any itemization of personal services. This provision limits the past predilection of lawmakers with po. itions and not with the programs of agencies.

c. There is a requirement that expenditures in the budget should be backed up by existing proposed revenue measures to avoid unplanned and injudicious spending. This requirement is designed to

limit deficit spending. In the past, expenditure measures were passed even without revenue backup.

d. There is a rule that no supplemental appropriation measures supported with existing revenue measures shall be enacted except those involving the creation of new offices or the undertaking of new programs or activities. This budgetary innovation is directed towards the past pernicious practices of passing supplemental budgets.

e. There is a prohibition against an increase of appropriations, enactment of additional special provisions, and against transfer of funds among the various branches.

f. There is delegation of authority to regional budget offices. This is intended to save time and effort in the processing of budget requests.

g. Procedures were streamlined to facilitate the approval of appropriations, limitations on budget debates, reenactment of the appropriations law of the preceding year's, implication of the veto power, unauthorized revisions during the printing of the budget, the use of Key Budgetary Inclusions (KBI), and cash advances on foreign-assisted projects.

h. Fund releases for the purchase of equipment are faster. For equipment amounting to P25,000.00 or less, no DBM analysis is needed because release is already automatic. For those which exceed this limit, the agency's annual equipment program is used for processing the request.

3. Budget Execution Phase

a. The comprehensive fund release system is considered the most important innovation in the budget execution phase. This system is a departure from the old practice of quarterly releases which often delay and hamper agency operations. The indicated quarterly amounts in the comprehensive release are automatically made available for expenditure at the beginning of each year.

b. There is a general rule that appropriations equal programmed funds unless a reserve is imposed. This departs from the old practice of appropriating more than what the treasury could be reasonably expected to fund.

c. Releases whose repetitive nature leads to machinization are computerized. In addition, the monitoring and reporting aspects are partially computerized to facilitate the administration of the budget allotment system.

d. There is monitoring of local counterpart support to foreign assisted projects. This is a very important innovation, especially since the government has been increasing the level of its borrowings. Lending institutions normally require counterpart commitments on the part of the borrowing agencies. Such commitments have implications on the budget. However, in some instances, agencies neglect to inform the DBM; such commitments cannot therefore be programmed. Tighter monitoring aims to avoid the danger of agency commitments to counterpart financing without coordination with DBM.

e. Other changes involved integrated funds programming, a better information system, and LOI 638 which calls for the evaluation of agency operations. Equally significant is the emphasis on interagency coordination.

4. **Budget Accountability Phase**

a. There is an expanded budget accountability under P.D. 1177. The decree provides the authorities concerned with a more reliable and authoritative analysis of the stewardship of public funds and the utilization of some public accounts.

b. There is continuous evaluation by the DBM of the quantitative and qualitative aspects of agency performance. This is reflected in the units of work measurement and other indications of agency performance like standard and actual costs per unit of work.

c. There is enhancement of budget monitoring and information system. The National Accounting and Finance Office of DBM now evaluates and analyzes the accounts and overall financial performance of the government [field reports on government expenditures for key national projects].

B. *Developments Since 1986*

1. **Budget Procedure**[48]

a. Program objectives and intended outputs are now made major determinants of funding levels, in the sense that the past practice of doing program budget only after budgetary decisions have been

made is replaced with simultaneous submission of physical targets and budget estimates by agencies;

b. The use of spatial and demographic impact of fund allocation is progressing through the application of physical and socioeconomic criteria in regional fund distribution.

c. Submission of 3 budget documents to the legislature is expected to improve decision making;

d. Budgetary decision making is extended to the budget execution stage through the preparation of work and financial plans (WFPs) which connects utilization of funds to scheduled accomplishment of agency outputs.

2. **Budget Structure**

The budget structure improved greatly in favor of provision of social services and of employment generating programs. However, an important policy area is the need for a budget allocation system that is responsive to the needs and priorities of each region.

3. **Budget Process**

a. The enhancement of regional development councils (RDCs) as a development and resource planning arm and the more dynamic involvement and interaction between development planning offices and fiscal and monetary agencies strengthen planning-budgeting linkage at the national and regional phases.

b. The participation of local officials, private sector and agency officials in the deliberation and decision making at RDC level emphasizes a process which is decentralized and consultative in nature.

c. Transparency is being practiced in all phases of the budget process, e.g., technical budget hearings are now opened to public scrutiny.

d. Recent efforts are directed towards streamlining and simplification of the budget process and strengthening of control and accountability mechanisms.

Meanwhile, NEDA and DBM are conceptualizing a synchronized planning-budgeting system which will "coordinate all planning-budgeting activities at policy and technical levels as well as at central and regional levels" with the objective of enhancing "the operational value to the Development

Plan and its programming documents and at the same time achieve a more focused resource allocation process."

In addition, there is still a need to effect and institutionalize more decentralized budgeting which will require further study of the relationships among local, regional and national bodies and the proper placement of decision centers.

IV. ISSUES AND PROBLEMS

Despite the reforms and innovations in the budgeting process begun during Martial Law years (and reinforced in P.D. 1177), Dr. Honesto Mendoza, then, foresaw some problems that may "continue to pester the budget system unless our policy-makers and government administrators change their fiscal orientation without being mandated to do so by the Constitution."

The problems mentioned by Dr. Mendoza, include the following:

1. the defective provision adopted from the 1935 Constitutions prohibiting budgetary riders;

2. the exclusion of a provision to give priority to capital projects already started over those not yet started in the general appropriation bill; and,

3. the dependence of the judiciary and other Constitutional bodies on the Congress and the President and his cabinet for the funds and their concomitant vulnerability to pressure therefrom.

Under the present system, the Judiciary and the Constitutional bodies undergo the same process as the other agencies in negotiating for their respective budgets. The independence of these agencies is guaranteed by the Constitution itself. Mendoza rightly points out that such independence might be diluted in the usual process of bargaining and compromising for budgets. In an attempt to insulate the Judiciary and Constitutional bodies from undue political pressure, the 1987 Constitution mandates, among others, that they shall enjoy fiscal autonomy. Their approved annual appropriations shall be released automatically and regularly, and the salary decrease cannot be effected during the continuance in office of Justices and during the tenure of Constitutional Commissioners.

Among the Constitutional bodies, the Commission on Audit has been proposing an alternative method in determining its budget. Using the concept of "cost of audit," the Commission proposed that its budget be computed as a percentage of the total resource budget. Since the degree and extent of audit work is largely influenced by the magnitude of expenditures ex-

pended on programs and projects, the Commission believes that computing the cost of audit on this basis is reasonable. Under this proposal, the budget of the Commission will be approved on a lump sum basis and it will have much needed flexibility in matching its budget with projected audit activities. The budget process will be considerably shortened and the Commission will not be vulnerable to pressure.

Some other problems that continue to hound government budgeting are identified by Assistant Director Gerardo F. Concepcion, Jr. of the DBM as follows:[49]

1. *Budgeting for Compliance.* More often than not, budget preparation becomes only a yearly "exercise in futility." Since it is simply taken as an activity for compliance, the resulting estimates are inadequately founded and generally not very realistic.

2. *Grave Deficiencies in the Planning-Budgeting Linkage.* The planning exercise still faces in one direction and budgeting in the other. They do not reinforce each other. During budget preparation, programming figures rarely come close to budgeting estimates. The justification too for the choice of projects looks only "good in paper."

3. *Bloated Budget Proposals.* This is common. The mentality "*baka makalusot*," is pathetic even to the straining revenue position of government. This "indiscretion" continues to waste time, money and effort in budget preparation.

4. *RDC's "Pitfall".* The usual "hometown" decisions of RDCs on budget proposals show the inherent biases for the interests of their respective regions. In effect, this results to a weak RDC regional bargaining position at the national levels.

5. *Expenditure-oriented Budgeting.* All budget-users tend to be motivated by an orientation to spend for pet capital outlay projects done in piece-meal or phase basis; i.e., phase I for this year, phase II for the next year, and so on. Usually, planners consider what to spend for and to get much in the budget to spend.

6. Budget Politicking. This refers to lobbying and "patronizing" favorite congressmen or senators to get what users wanted, not what is needed, regardless of demeaning effects this has on the development direction of the budget for the year.

In the light of the foregoing discussion and the experiences indicated regarding budget reforms made inherent in the shift from one dominant

budgetary approach to another, it may be safely assumed that "budget reform like other aspects of administration operates within a zone of acceptance." But such "acceptance" may either be a passive, active or superficial one. For again, when a mandate is called for adoption of budget reforms such as ZBB or regionalized budgeting, everyone in the hierarchy of officials agree in unison and profess to apply the same. In reality, however, it takes time for reforms to really sink in and be integrated in the administrative system. When an innovation is introduced, agencies follow for compliance sake. This can be true for budget reforms. For example, former Minister of the Budget, Jaime Laya, commented that while performance budgetary was first introduced during the 50's it was only under P.D. 1177 that it was really enforced.

A. Budget reforms and the political system. Aaron Wildavsky identifies the following political implications of the budget:

1. The budget is inextricably linked to the political system. An implication therefore is that changes in the budget can only be effective and meaningful if there are basic political changes as well.

2. No significant change can be made in the budgetary process without affecting the political process. There could be no point in tinkering with the budgetary machinery if, in the end, the politics of the budgetary decision-making has not changed.

3. Since the budget represents conflicts over whose preferences shall prevail, the third implication is that one cannot do "better budgeting" without considering who benefits and who loses, or demonstrating that no one loses.

Such observation of Wildawsky are further reinforced by Naomi Caiden in her attempt to reexamine the common assumptions when speaking of budgeting in poor countries. With the assumption that "politics is not as important as economics," Caiden emphatically noted that...budget policy decisions are, in the last resort, political decisions; budgetary information serves political purposes and budgetary estimates reflect political preferences and ideology.[50] Moreover, the ability of the government to raise revenue for what should be public needs depends not only on the economic resources and economic structure of the country but also on the willingness of the population to provide those revenues.

The budget reforms under P.D. 1177 undeniably takes into consideration political abuses under the old system of budgetary legislation. The reforms discussed earlier are designed to limit such malpractices. However, while the formal legislative process reflects such reforms, informal arrangements still persist. This is because the political system does not consist only of formal structures and processes but is also shaped by personalities and

well-entrenched political traditions and practices. Furthermore, budgeting is essentially allocation of resources. Such allocation cannot help but reflect the balance of power in any political system. Agencies and individuals with more access to political power would naturally have more access to budgetary support.

It takes political risk-taking and statesmanship of the highest order to transfer financial resources to the politically weak. Under normal circumstances, the politically powerful will have priority over resources. It must also be noted that under the present system, budget legislation is vested in Congress.

Formerly, with the executive and legislative powers vested in one man, agencies, particularly corporations were created by mere Executive Order without going through the legislative mill prescribed in P.D. 1177. While this arrangement sped up decision-making and action on urgent problems, critical allocation decisions were made without undergoing public scrutiny and debate.

Expenditures have to be programmed under our present budgetary system. However, in a developing country, political decisions have to be made even after expenditures have been carefully programmed. For example, decisions to hold referenda and elections have heavy cost implications yet they cannot be programmed and predicted. Responses to various national crises have implications on the budget and, again, these cannot be programmed.

It must be emphasized that when we discuss budgetary politics, we are referring not only to the budget legislation process but the entire budget cycle which we maintain is influenced by the political system. Budget reforms reflect attempts to rationalize the allocation process. Unfortunately, political processes do not respond to the logic of technical procedures at all times.

B. Budget reforms and the economic system. Dr. Jose Soberano has commented that developing countries have adopted budget techniques which were developed in economies of abundance. Unfortunately, these have to be applied in economies of poverty. Thus, the most sophisticated budget techniques cannot prevail against unprogrammed economic crises. A well-planned budget can be easily derailed by a major natural catastrophe like an earthquake, a massive flood or prolonged draught. A slowdown in productivity of the economy will automatically result in reduced revenues even as pressures build up for expansion of government expenditures. Budgeting is primarily forecasting of revenues and expenditures of government programs and projects. Unfortunately, the behavior of poor economies are difficult to predict since so many variables cannot be controlled. A very recent example is the budget for CY 1983 which had to be cut by 18 percent

after it was passed into law. Budgeting therefore not only calls for rational allocation techniques. It demands great skill in identifying and responding to urgent economic problems without necessarily sacrificing budgetary thrusts and priorities.

C. Budget reforms and the international environment. John Heller describes poor economies as "exposed" economies in the sense that these are subjected to unpredictable international economic and political influences. The continuing influence of former mother countries on developing countries has been noted. International lending institutions exert tremendous influence on the budgetary decisions of debtor countries. If the fundamental interests of the developing country and the external "adviser" coincide, well and good. Unfortunately, these can be non- complementary. Even analyses of the causes of chronic development problems can differ, resulting in different budgetary solutions. What is recommended does not necessarily work out. Under such circumstances, budget techniques can only go so far.

To summarize, sweeping budgetary reforms have been instituted since 1973. These innovations are very impressive and their importance cannot be minimized. The impact of these reforms are only starting to be felt. However, it must also be borne in mind that these reforms and other admirable reforms in the fiscal administration front can only be effective within the context of a supportive politico-economic system and a facilitative international environment. In closing, the United Nations position on the subject is noteworthy:

> *"No budgetary system, classical or modern, can be translated to another country without being adapted to national conditions. While techniques are neutral, men are not, and among the various techniques, the choice must fall on those which fit the individual country's requirements and traditions more easily. In particular, they must be adjusted in the manner best suited to the economic, political and social conditions of the country concerned."*

ENDNOTES

[1]Taken mostly from the DBM Lecture Notes on Government Budgeting.

[2]DBM Lecture Notes.

[3]*Ibid.*

[4]*Ibid.*

[5]*Ibid.*

[6]*Ibid.*

[7]Sec. 4, Book VI, Revised Administrative Code of 1987.

[8]DBM Lecture Notes.

[9]*Ibid.*

[10]Sec. 14, Book VI, Revised Administrative Code of 1987.

[11]May be related to Section 15 where the Secretary identifies by region the expenditure programs of agencies in the national budget.

[12]Sec. 11, Book VI, Revised Administrative Code of 1987 (RAC).

[13]Sec. 12 (1), Book VI, RAC.

[14]Sec. 12 (2) Book VI, RAC.

[15]DBM Lecture Notes.

[16]Sec. 29 (1), Article VI, Constitution.

[17]Art. VII, Sec. 22, Constitution.

[18]Art. VI, Sec. 24, Constitution.

[19]DBM Lecture Notes.

[20]*Ibid.*

[21]*Ibid.*

[22]*Ibid.*

[23]*Ibid.*

[24]Art. VI, Sec. 25 (7), Constitution.

[25]191 SCRA 452.

[26]DBM Lecture Notes.

[27]*Ibid.*

[28]*Ibid.*

[29]*Ibid.*

[30]*Ibid.*

[31]*Ibid.*

[32]*Ibid.*

[33]*Ibid.*

[34]*Ibid.*

[35]*Ibid.*

[36]*Ibid.*

[37]*Ibid.*

[38]*Ibid.*

[39]*Ibid.*

[40]*Ibid.*

[41]*Ibid.*

[42]*Ibid.*

[43]*Ibid.*

[44]*Ibid.*

[45]*Ibid.*

[46]*Ibid.*

[47]See Aaron Wildavsky's discussion on the "Politics of Budget Reform," in his book The Politics of the Budget Process, p. 131- 133.

[48]DBM, "Budget Process: Lecture Guide".

[49]rardo F. Concepcion, Jr., "Budgeting: The Development Perspective," in Budget gement Bulletin, Vol. 1 No. 5, pp. 13-14.

mi Caiden, "Budgeting in Poor Countries: Ten Common Assumptions Re-examined," Public Administration Review, Vol No. January-February 1980, pp. 43-44.

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LEONOR MAGTOLIS BRIONES

PHILIPPINE PUBLIC FISCAL ADMINISTRATION

VOLUME II

SECOND EDITION

LEONOR M. BRIONES

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FOREWORD

This volume on Fiscal Administration is a revision of a 1983 edition. It is now the principal textbook for fiscal administration and public finance courses supported by the Fiscal Administration Foundation, Inc. It is also used in leading Colleges and Universities like the University of the Philippines, Silliman University, Philippine School of Business Administration and St. Thomas Aquinas University.

It is now published in 2 volumes. Volume I covering - Public Fiscal Management, Development, Revenues and Expenditures, and State Budget, while Volume II covers Sovereign Debts, State Accounting, State Auditing and Government-Owned or Controlled Corporations.

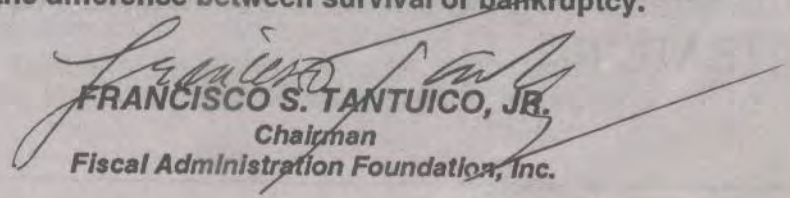
James Madison, the third American president, a century and a half ago, so aptly warned that: "A popular government, without popular information or means of acquiring it, is but a prologue to a farce or a tragedy, or perhaps both. Knowledge will forever govern ignorance, and a people who mean to be governors must arm themselves with power which knowledge gives."

Indeed, farce and tragedy are already with us. And the government overload and fiscal stresses that confront the nation will stay with us for decades more. But it is never too late.

FAFI by promoting courses in fiscal administration has started to make financial management an integral part of public administration. There is no other way. A separate discipline for the public fiscal sector has to evolve from our very own efforts, to find its central place in government management.

From this small beginning, our schools, the bureaucracy, our policy makers, the governed, and most importantly, our youth, must join in to build the critical mass in our society which will possess that "power which knowledge gives."

The need for competence and courage, for fiscal managers, trained, tempered and educated in the art of government, is critical. It could spell the difference between survival or bankruptcy.



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FISCAL ADMINISTRATION FOUNDATION, INC. (FAFI)

The Fiscal Administration Foundation, Inc. (FAFI) is a non-profit, non-governmental, non-partisan foundation registered with the Securities and Exchange Commission in 1977 under Philippine Laws.

FAFI assists schools, conducts research, training and consultancy in Public Finance, and Fiscal Administration. It is dedicated to the promotion of knowledge in the areas of fiscal administration, such as state accounting, auditing and internal control, budgeting, public enterprises and their privatization, public accountability and distance education.

FAFI maintains a specialized library for the purpose. It publishes the Public Ledger Magazine.

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COURSE DESCRIPTION

Volume II of the book is divided into four major parts. Part IV focuses on what is perhaps the most controversial aspect of public finance for LDC's - public borrowings. This is an activity whose impact on LDC's has not been clearly established but ironically, this is also a fiscal tool which LDC's are using with vigor, whether as a matter of policy or as a result of circumstance. Perhaps, one can even safely say that public borrowing is the most significant activity currently pursued in public fiscal administration by most LDC's. This aspect of fiscal policy is fraught with controversy and disagreement not only among policymakers who accept it in one way or another but also among various sectors of society. The significance of the subject lies in the fact that it is obviously linked to the development efforts of LDC's. Borrowing is the primary tool used for financing development projects. Thus, it is a major component of development finance. Chapter 14 makes a survey of theories of public debt and their applicability to developing countries. It includes a discussion of issues on public borrowings which are confronted by the developing countries. A note on the national government domestic debt is attached to complement the discussion and to show how the foreign debt resulted in the ballooning of domestic debts. Moreover, due to the worsening of the debt problem, studies now focus on debt management strategies. Chapters 15 and 16 are new chapters which highlight issues now becoming relevant due to their increasing impact on Public Finance. Both chapters touch on international constraints to public fiscal administration which include the fast growing influence of external forces on our economy.

The accountability aspect of the public fiscal administration, namely: (1) a technical description of concepts, theories and practices in the state accounting system and discussion of issues and problems in state accounting in the country, and (2) the state auditing in the Philippines, the developments in state audit and the current thrusts and priorities are covered in Part V (Chapter 17) and Part VI (Chapter 18), respectively. A detailed discussion of issues and problems in state audit is also included.

Part VII, (Chapter 19) covers government-owned and controlled corporations (GOCC) the activities of which are related with the problems of public administration. GOCCs play a major role in the economies of developing countries, in areas of monopoly power, capital formation, lack of private initiative, control in strategic sectors and ideological motivation.

It may be recalled that Volume I of the book is divided into three major parts. Part I introduced the basic ideas of public fiscal management, the development of public finance institutions, the legal and political basis of public fiscal administration, fiscal policy formulation and implemntation in the Philippines, including the issues and problems in development finance. Part II discussed the resource generation policies and activities of the government through taxation and other forms of revenue. Part III covered government budgeting and expenditure policy, as well as the interplay of political, social and economic factors, and the Philippine experience.

PART IV

SOVEREIGN DEBTS

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CHAPTER 14

THEORIES OF PUBLIC BORROWINGS

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NOTES ON THE NATIONAL GOVERNMENT DOMESTIC DEBT

THEORIES OF PUBLIC BORROWINGS

Introductory Note

This Chapter was written in 1982-83, several months before the Philippines went into the debt crisis. Nevertheless, most of what has been written still applies. In fact, it was able to foresee what was about to happen in 1983 and even went as far as providing some possible ways to minimize the effects of an impending debt crisis. So, it was decided to keep the chapter as it is. However, the important developments since then could not just be neglected. To take these into account, a postscript is added which highlights the events which triggered the foreign debt and balance of payment crises and points to the feasible alternatives to get out of the predicament.

After borrowing and going into a debt trap, studies now have shifted attention to debt management. Various models on "debt solutions" rather than debt as a solution (to the mounting budget deficit) are cropping up. A relatively recent paper by W. Eberlei on "Ways Out of the Debt Crisis" provides comprehensive groupings and background of these models. Due to the importance of this section and for fear of not being able to give an exhaustive review as Eberlei, it was decided to annex the relevant portions of the paper.

I. INTRODUCTION

Public borrowing is a fairly modern practice in public finance. During the medieval period very little borrowing was done. In the mercantilist period, the benefits of borrowing started to be recognized; however, these were later looked upon with disfavor during the "classical" years of capitalism. Adam Smith led the economists of his time in strongly criticizing the "evils" of borrowing and the virtues of the balanced budget.

Borrowing as a powerful tool of fiscal policy gained ascendancy during the time of John Maynard Keynes with his advocacy of deficit financing and the unbalanced budget at the time of the Great Depression. Keynes considered borrowing as an important tool for achieving economic objectives, particularly stability in the economy.

Since Keynes, there has been little debate on the importance of borrowing especially in the industrialized countries. To them, it is merely one of the fiscal policy tools resorted to for compensatory purposes.

In the LDCs, however, the issue of public borrowing is not only an economic issue; it is a political issue, as well. All aspects of public fiscal administration are controversial and even emotion-laden - be it fiscal policy, budgeting, spending, accountability or even graft and corruption. Nevertheless, in LDCs no other fiscal issue touches off more passionate defense and attack than borrowing. Why is this so?

For one, LDCs are relying more and more on borrowing not so much as a compensatory tool but more as a major source of funds for government expenditures.

In the Philippines, the government has been negotiating for additional loans from the multilateral (World Bank and IMF) and bilateral sources to cover its ever increasing budget deficit.

In addition, external borrowing touches on international politics and on sensitive issues like interference in internal affairs, disadvantageous preconditions for borrowing, non- economic costs and even national sovereignty. In LDCs, discussions on these subjects spark off disagreement since these are rooted in diametrically opposing interpretations of the causes of underdevelopment.

In this chapter, an attempt will be made to review current theories on public debt and how these apply to developing countries. For purposes of discussion, these have been divided into three theoretical groups. The developing country adaptations of the Keynesian theory of deficit-financing are described first. The second is on development finance and borrowing. The third group of theories refer to those described by Todaro as "international-structuralist" theories.

II. THE DEVELOPING COUNTRY ADAPTATIONS OF KEYNESIAN THEORY OF DEFICIT-FINANCING

When Keynes postulated his views on deficit-financing, he had the industrialized countries of Europe and the United States in mind. The LDCs were probably farthest from his thoughts. Yet, during the Development Decades, Keynes - derived concepts were very evident in LDC development programs. As discussed in Chapter 2, the developing countries regained their independence after World War II at a time when Keynes' ideas were firmly entrenched in the industrialized countries. Keynes theories responded to the needs of economies threatened by instabilities like inflation, high rates of unemployment, low productivity, and so on. Developing countries easily identified their economies with those described by Keynes; they apparently had the "same" problems. Since Keynes' advice worked spectacularly during the Great Depression, LDCs hoped that these would work as well in

conditions of underdevelopment. His ideas were therefore adapted to LDC conditions, especially that of deficit-financing or borrowing.

Keynes postulated that under certain conditions a balanced budget may not be useful. As explained by Groves and Bish, during an economic slump, government has to compensate for the inactivity of the private sector. Expenditures called for might be of "startling magnitude." If these have to be balanced by an equally large increase in taxes, the matter might have a discouraging effect on investment. On the other hand, the large expenditure programs may actively compete with business growth. In other words, if an economic crisis is very serious, the magnitude of government compensatory activities might require a very large budget; if expenditures and taxes are raised in a balanced manner, such a budget will "be of little practical value." An unbalanced budget may be more effective.[1]

Government manipulation of taxes and expenditures have aggregate effects of the economy. Together with borrowing, these tolls can be utilized in harmony with monetary policy to offset instability in the economy. Compensatory fiscal policy would then be characterized by (1) a budgetary deficit during the depression phase of a business cycle; (2) a balanced budget in times of full employment and stable prices; and (3) a budgetary surplus during inflationary periods.[2] Thus, the budget may be balanced or unbalanced depending on the state of the economy and the type of problem which has to be addressed. Since full employment and stable prices are hardly attainable on a continuous level, it is not therefore possible to have a balanced budget all the time. Deficit-financing, or borrowing becomes a necessity.

Borrowing as a compensatory fiscal tool is limited in LDCs because of the absence of institutional prerequisites. A significant sector of the economy is still non-monetized and money and capital markets are still underdeveloped or plagued with "behavioral" problems. Manipulation of debt management tools is therefore very difficult.[3]

Nevertheless, based on the Keynes postulate of the role of government in attaining economic stability, borrowing is considered acceptable for various purposes in LDCs. Borrowing for current expenditures is generally frowned on. It is considered necessary for capital generation purposes, like setting up public enterprises which will contribute to productive output.

Yoingco points out that public debt generally undergoes four stages during its life span: The stage of borrowing funds, spending the funds, raising revenues for repayment and actual debt repayment. Each of these stages affects the structure of taxes, the levels of expenditures for consumption, and investment. These are described as "economic effects of public debt."[4] Therefore the sources of borrowed funds whether local or foreign, the type

of debt instrument, the purpose of borrowing, and even the maturity date of a major public loan are all carefully considered in terms of the specific impacts they are expected to create on the economy. Within this context, it its therefore considered indispensable in the endless search for stability.

Keynes-influenced ideas, however, did not completely work as expected in LDCs. Firstly, Keynesian theory was applied mainly to internal borrowings. As a compensatory tool, it was used to mop up excess liquidity in the economy, as in time of inflation. It was also used as a tool for transferring resources from one sector to another within the economic system. However, since administrative and institutional mechanisms for borrowing are still largely undeveloped or defective in LDCs, abuses in the financial market created more problems instead of solving existing ones. In an LDC, a single financial scandal of considerable magnitude can rock the financial system and have reverberations on the entire economy.

The use of Keynesian-inspired techniques to correct internal instability did not completely answer the problems of LDCs. This is because the instabilities of LDCs are primarily of external origin like the oil crisis, inflation and recession in the industrialized countries. Such tools therefore did not address the larger problem of LDCs.

Secondly, Keynes' theories are based on the assumption of fully developed economies undergoing cyclical difficulties. Fiscal policy tools were used to stimulate the economy back to activity. In LDCs, productive capacity is not yet fully developed; it has to be built up yet. Thus, when stimulants are applied on an assumed capacity which does not actually exist, the result tends to be inflationary.

As early as the middle '60s, fiscal administration professors in the Philippines were already pointing out why Keynesian theories cannot work in an LDC. Their favorite example is the Emergency Employment Administration during the Macapagal era. At that time, deficit-financing was resorted to in order to finance the program. The objective was to provide jobs for the increasing number of unemployed in the country. A massive program of employment generation was therefore set up. The unemployed and unskilled were given jobs building roads, digging canals and so on. However, there was no substantial increase in productivity in terms of manufacturing and industrial output. The effect was to give the unemployed increased purchasing power. However, since production did not catch up with purchasing power, prices naturally went up. Even the employment-generation activity had to be dropped eventually and the EEA was disbanded.

The program was based on the "pump-priming" technique which was used in the United States during the time of the Great Depression. The economy was likened to a water pump which had to be primed (via deficit-

financing) in order to draw up water or productive capacity. Economists pointed out that pouring massive resources into the economy is useless when the economic water pump is defective or worse still, non-existent. The Philippine experience is not an isolated one. Rajah Chelliah observed in his book; "Fiscal Policy in Underdeveloped Countries" that Keynesian policy did not work in LDCs, particularly in India.[5]

In spite of the fact that Keynesian economics had been criticized as far back as the late 60s, LDC fiscal policies continue to have variations of Keynesian ideas. Thus, governments borrow heavily in order to finance massive programs designed to generate employment and productivity on a nationwide basis. Borrowed funds are in turn re-lent to citizens at very attractive rates. Since these programs are launched on a nationwide basis, the administrative requirements for monitoring hundreds of thousands of small loans are tremendous. Whether such programs will create employment and productivity bear watching.

One hopes that the favor with which such programs are usually launched will conquer the difficulties of past experience. In spite of the fact that borrowing is theoretically acceptable, it is not yet internalized in many LDCs as an economic institution. Thus, we may have many instances of people eager to borrow but unwilling to pay, as indicated in alarming rate of defaults in payments of loans, whether these are small loans to farmers or jumbo loan packages to local industrialists who conveniently slip out of the country whether the going gets rough. The funds which government re-lend to various sectors of the economy are largely deficit-financed. Massive defaults therefore create repayment problems for the government in addition to other economic effects.

Nevertheless, deficit-financing theory continues to be very attractive to LDCs. After all, it justifies an activity - borrowing - to which LDCs in a hurry may not have found a faster and easier alternative.

III. DEVELOPMENT FINANCE

Borrowing is considered an important fiscal tool in Keynesian theory. In development finance, it is not just a tool, it is an integral part. The Keynesian theory of borrowing as a compensatory tool especially in controlling inflation is applied mainly to internal borrowing. On the other hand, development finance is primarily predicated on foreign borrowing.

The expenditure demands of development are enormous. This is true whether an LDC faithfully follows the stages of economic growth theory and dutifully accumulates capital for all-important "take-off stage;" whether the heavy instrument requirements of the Harrod-Domar model serve as the guide; or whether an LDC attempts to respond simultaneously to all

development necessities - economic, social, cultural and even spiritual. Development is not only expensive; it is urgent. Internally generated sources are not enough. Under such a development scenario, the only immediate option recommended by experts is borrowing, specifically foreign borrowing.

It is not therefore surprising that sharp escalations in levels of borrowing in LDCs coincide with aggressive development spending.

Musgrave and Musgrave point out that in development finance, foreign borrowing is preferable to local borrowing. With the latter, "public investment which is financed by (local) borrowing does not add to capital formation if it merely diverts funds otherwise available for private investment. The situation is different, however, if borrowing is from abroad. In this case, additional resources become available as borrowing is accompanied by increased imports." Investment therefore goes up, inducing accelerated growth rate even with a lower rate of tax. A higher rate of current consumption also develops. To continue, "it is thus the income gain to domestic factors which renders foreign borrowing so important an instrument of development policy. Other useful functions of capital import include the provision of foreign exchange and the collateral advantages gained from the introduction of advanced technology and managerial know-how."[6]

Borrowing therefore emerges as an alternative to imposing higher rates of taxes in development finance. Foreign borrowings is preferred since this results in inflow of additional resources. Furthermore, development requirements require massive flows of foreign exchange. Such a need cannot be met by earnings from trade alone since LDCs normally have unfavorable balances of trade with the industrialized countries. Foreign borrowings are therefore resorted to in order to cover up foreign exchange deficiencies due to development spending. Finally, it is claimed in development finance that foreign borrowing facilitates the inflow of technical and managerial expertise to LDCs. Again, this activity requires substantial foreign exchange.

It is interesting to note that the Development Decades are characterized by two interrelated developments: the sharp rise in borrowing activities of the LDCs and the emergence of the World Bank and the International Monetary Fund as the dominant figures in development. More than any other, these two institutions have influenced public debt theory for LDCs through their lending policies, the conditions attached to their loans, and advice given by their consultants and theoretical discussions in their research publications. Also, these two institutions have the most extensive data on nearly all facets of life in LDCs - be it economics, politics, culture or even rumors of impending revolution. It can even be said perhaps that they know more about LDCs (especially on economics) than the LDCs themselves. Their country reports, staff papers, special studies, annual reports, and their joint publication, Finance and Development contain very detailed

information on LDCs. These publications also reveal their basic philosophy about borrowing for development. Considering their pervasive influence on LDC policies and activities, a brief discussion of these two institutions is therefore in order.

A. *The International Monetary Fund.*[7] The fund as it is popularly called, was conceptualized together with the World Bank in the famous Bretton Woods Conference held in 1944, just before the end of World War II. The United States was the richest and most powerful nation at that time, played a dominant role in designing these two institutions. During the negotiations and planning, the LDCs were not on the agenda; most of them were still engaged in struggles for national independence. The Fund was created out of the need to promote free international trade and facilitate the inflow and outflow of goods, services and currency among the major powers at that time. The United States was concerned about the protectionist practices of the European countries through the use of exchange restrictions and bilateral agreements.

The Articles of the Fund show a definite bias against exchange controls. Article VIII provides that:

> *"...no member may, without the approval of the Fund, impose restrictions on the making of payments or transfers for current international transactions, or engage in discriminatory currency arrangements or multiple currency practices..."*[8]

Thus, the Fund developed an ideology of development, and in the process, of public debt for LDCs which reflected the free trade ideology of its most powerful member, the United States. Unfortunately, free trade is mainly free for the industrialized trading partners; it has been historically proven disastrous for the LDCs, as in the Philippine experience with the United States in free trade.[9]

In its involvement with LDCs, the Fund imposes Stand-by Arrangement and Stabilization Programme as part of a loan package to an LDC. Although details vary according to the specific situation of a borrower LDC, the basic components are the following:[10]

1) Abolition or liberalization of foreign exchange and import controls;

2) Devaluation of the exchange rate;

3) Domestic anti-inflationary programmes, including:

(a) control of bank credit; higher interest rates and perhaps higher reserve requirements;

(b) control of the government deficit; curbs on spending; increases in taxes and in prices charged by public enterprises; abolition of consumer subsidies;

(c) control of wage rises, so far as within the government's power;

(d) dismantling of price controls.

4) Greater hospitality to foreign investment.[11]

The above conditions on LDC borrowing reflect a theoretical framework hewing to the classic free enterprise laissez faire philosophy.

As a rule, the Fund gives loans which help out LDCs with their Balance of Payments problems while the World Bank grants loans which are directly applied to development projects. Lately however, there has been some overlapping, as reflected in their loans to the Philippines. The World Bank in 1980 granted a structural adjustment loan of $200 million to the Philippines. At the end of 1982, the World Bank joined the IMF in granting additional loans to the Philippines to bail it out of its BOP deficit of over $1 billion.[12]

B. *The World Bank.* The Bank is actually a group of banks, originating with the International Bank of Reconstruction and Development (IBRD). As in the case of the IMF, the IBRD was formed at the instance of the United States to assist in the recovery and reconstruction of countries devastated by World War II, so that these countries would continue participating in free trade. The other institutions in the World Bank Group are the International Development Association founded in 1960 and the International Finance Corporation (IFC) which was organized in 1956.

As in the case of the IMF, when the World Bank was created, the LDCs were not the focus of concern. The first recipients of program loans were four European countries: France, Netherlands, Denmark and Luxembourg. By 1949, the Bank shifted from "reconstruction" to development lending in the wake of the increasing number of colonies who declared their independence. Since then, the focus of the World Bank has been the LDCs. This is clearly indicated in the comparison made by Cheryl Payer of major shareholders and major borrowers, thus:[13]

Major shareholders of IBRD, per cent of voting power (June 30, 1981)

United States	20.84	China	3.47
United Kingdom	7.44	India	3.28
Germany, Fed. Rep.	5.06	Canada	3.22
France	5.05	Italy	2.94
Japan	5.04	Netherlands	2.25
		Belgium	2.13

Percent held by top 5 43.43 Percent held by top 12 62.62

Major borrowers from IBRD with percent of loans outstanding (June 30, 1981)

Brazil	9.73	Thailand	3.60
Mexico	7.92	Romania	3.24
Indonesia	6.59	India	3.15
Korea	5.63	Nigeria	2.84
Turkey	5.11	Morocco	2.64
Columbia	5.02	Argentina	2.10
Philippines	4.90	Malaysia	2.10
Yugoslavia	4.65	Egypt	2.01
		Algeria	1.91

Percent held by top 8 49.55 Percent held by top 70 73.14

The major borrowers of World Bank are primarily LDCs. It is interesting to note that the Philippines is among the top eight borrowers of the World Bank with outstanding loans totaling $4.9 billion as of June 30, 1981.

On the other hand, the major shareholders of the Bank are industrialized countries. Out of 139 member countries, five countries control 43.43% of the voting power; the top twelve shareholders control 62.62% of the voting power.

World Bank loans to LDCs during the 1950s were mainly in infrastructure. The emphasis is consistent with the prevailing view that infrastructure serves as the foundation for economic development. Thus, transportation, communications and electric power account for major bulk of World Bank loans.

During the past two decades, the World Bank has widened the scope of its lending to all other sectors. Thus, the World Bank has been granting loans not only for infrastructure projects but also for mining, oil and gas, agriculture and rural development, water resources, forestry and tree farming, "urban shelters" and education.

Loans are usually on a program/project basis. Standard requirements are feasibility project studies which should indicate how revenue can be granted for repayment. The magnitude of the World Bank lending operations in LDCs can be appreciated better if we consider the fact that at the end of 1980, total loans and credits amounted to nearly $80 billion.

C. *World Bank/IMF Development Finance*. Cheryl Payer gives a detailed description of how IMF operates in the LDCs in her book, "The Debt Trap: IMF and the Third World". She analyzes World Bank operations in her other book, "The World Bank: A Critical Analysis". Considering their combined influence and development finance for LDCs, what theoretical assumptions form the basis of their lending policies?

Both institutions clearly support the philosophy of the free trade which has been espoused by the industrialized countries, particularly the major financier of these two institutions, the United States. Their philosophy of lending (or of borrowing, from the point of view of LDCs) is predicated on assured free flow of goods and services from the industrialized countries who are major shareholders in these institutions to the LDCs. Such philosophy is indicated in their lending conditions which usually complement each other.

The World Bank vision of development includes massive borrowing for large-scale infrastructure projects and other equally gargantuan programs. The sheer size and magnitude of these loans result in heavy imports of

materials, expertise and technology. Not surprisingly, unprecedented levels of importation also bring on unprecedented levels of instability as explained in Chapter 3. The IMF then comes in with its stabilization programmes which are considered sine qua non for BOP loans. The conditions attached to these loans reflect the free enterprise philosophy. For example, public enterprises are normally required to raise their rates of basic services. Subsidies are discouraged. Nevertheless, in LDCs, governments are generally compelled to produce and distribute basic services at subsidized prices out of sheer necessity. Taxes are also required to be raised even as constraints inherent in the tax systems of LDCs limit the effectiveness of this fiscal tool. Devaluation is encouraged and foreign investments highly recommended.

Public borrowing in development finance is therefore an extension of free enterprise theory which espouses free trade. The two institutions which dominate development finance consistently reflect this in their loan conditions.

IV. DEVELOPMENT FINANCE: ANOTHER VIEW

The third group of theories on public borrowing are described as the International Structuralist model. These are views which are critical of the current approaches to development finance as postulated by the World Bank and IMF. Actually, the international structuralists are part of the growing number of scholars and writers who are pointing out the disastrous consequences of World Bank - IMF financed LDC borrowing on the LDCs themselves.

Marxist-Leninist scholars view the present relationship between mixed economy LDCs, the advanced countries and the WB-IMF as a logical continuation of the theory of imperialism as originally postulated by V.I. Lenin. He described the historical development of capitalism and explained how imperialism resulted out of concentration and expansion of capital, the need to export finance capital, find new markets and conquer colonies. At present there is no physical occupation of former colonies by their former colonial master; however, the colonial relationship continues through political and economic dominance which is described as "neo-colonial." This is done through unfavorable trade relationships, establishment of military bases, foreign investment, interference in political affairs, foreign aid and borrowing, and other forms of control. Even if LDCs are supposedly independent, they are still under imperialist control. Thus, imperialism has assumed a new form, neo-colonialism.

On the other hand, the dependency theory is called neo- Marxist, since its framework was developed from Marxist theory. A leading dependency theorist, Dos Santos, defines dependence as a conditioning situation

wherein the economies of one group of countries (dependent economies) are conditioned by the development and expansion of others (industrialized economies).[14] Dependence is based on an international division of labor which allows industrial development to take place in some countries while restricting it in others whose growth is conditioned by and subjected to the power centers of the world.[15] The concept of dependence takes into account the articulation of dominant interests in both the power centers and the dependent societies - that is, domination is only possible when it is supported by the local elite groups which profit from it.[16] This concept explains the contemporary struggles within these countries and also the interaction between them in the developed capitalist economies. The conditions of dependency as it is argued encompasses all or most of the following features:[17]

1. From their common historical background (colonialism), LDCs have inherited particular structures of production and trade, in particular, the production of primary commodities (raw materials and food-stuffs) for export to the developed capitalist economies.

2. They were initially dependent on imports for their manufacturing requirements. With the gradual establishment of import-substituting consumer goods, industries, they become dependent on imports of intermediate and capital goods.

3. Partly, as a result of industrial development, they are heavily dependent on imports of foreign technology, although this form of dependency covers many other spheres of activity, like agriculture, communications, education, medicine and so on.

4. The LDCs, in general, are deeply penetrated by foreign capital largely in the guise of the transnational corporations (TNCs) with its associated patterns of production, consumption, marketing, expertise, etc.

5. At the very general level, there exists a condition of cultural, psychological, social and political independence. Minimal political independence has been gained by all but a few LDCs, but this has not been matched by economic independence, a phenomenon which was first generally recognized in the early 1960's in independent Africa and which gave rise to the concept of neo-colonialism.

Distinguished national scholars have also consistently warned against the unfavorable impact of WB-IMF programs on LDC economies. In the case of the Philippines, Alejandro A. Lichauco has written an extensive case study on the country's neo-colonial history and the role of the WB-IMF in perpetuating underdevelopment. "Mortgaging the Future: The World Bank and the

IMF in the Philippines", edited by Vivencio R. Jose contains incisive and critical essays by nationalist writers on the issue. The book contains a wealth of detail on specific World Bank and IMF programs in the Philippines.

Cheryl Payer on the other hand, insists that "the World Bank has deliberately and consciously used its financial power to promote the interests of private, international capital in its expansion to every corner of the 'underdeveloped' world. It has worked toward this end in many different ways:

- By acting as intermediary for the flow of funds abroad, with taxpayers' money from its developed member countries serving to guarantee the safety of the bonds it sells;

- By opening up previously remote regions through transportation and telecommunications' investments, thus destroying the natural protection such regions had previously enjoyed;

- By directly aiding certain multinational corporations, notably but not exclusively, in the mining sector;

- By pressuring the borrowing governments to improve the legal privileges for the tax liabilities of foreign investments;

- By insisting on production for export which chiefly benefits the corporation that controls international trade;

- By selectively refusing to loan to governments that repudiate international debts or national foreign property;

- By opposing minimum wage laws, trade union activity, and all kinds of measures that would improve the share of labor in the national income;

- By insisting on procurement through international competitive bidding, which favors the largest multinationals;

- By opposing all kinds of protection for locally-owned business and industry; and

- By financing projects and promoting national policies that deny control of basic resources-land, water, forest to poor people and appropriate them for the benefit of multinational and their collaborative local elites.[18]

Critics of the World Bank-IMF group emphasize that through the mechanism of development finance through borrowing, these institutions perpetuate underdevelopment in LDCs. What they are saying is that borrowing benefits the institutional lenders and their dominant shareholders more than the recipients of such loans.

V. SUMMARY

The preceding has been a discussion of various theories touching on the issue of public borrowing. It was pointed out that the idea of public borrowing was introduced by Keynes during the Great Depression, mainly as a compensatory tool in times of economic stability. However, it was only after World War II that public borrowing assumed prominence. Initially, it was resorted to, through the mechanism of the World Bank and IMF, to restore stability to war-ravaged industrial nations and reconstruct their economies. Eventually, it developed into an integral part of development finance for LDCs, again through World Bank and IMF, the two most dominant institutions in the field.

There are two major groups of theories which have radically different views on the impact of borrowing, as it is currently practiced, on LDCs. Development finance is dominated by the free enterprise ideology of World Bank and IMF which seeks to open up LDC economies to international free trade. On the other hand, critics of development finance, while varying in their political outlooks, state that development finance through borrowing perpetuates underdevelopment even as it benefits the industrialized countries. Interestingly, the Keynesian theory, borrowing is used to control instability; ironically, in development finance, critics say that borrowing itself exacerbates instability.

VI. CONCLUSION

For the past thirty years, the spirited debate between the opposing camps on public borrowing has been going on since the emergence of the World Bank and IMF as major figures in development finance. In the meantime, recent events have dramatized the debate and brought the issue of LDC borrowings into sharp focus. The decade of the '80s has ushered in instabilities among the industrialized capitalist countries. In turn, these instabilities have been exported to the LDCs through trade, investment and most of all, through borrowing. Herbert Wilkens warns that the external debts of the LDCs reached the level $625 billion by the end of 1982. He estimates that actual totals could even exceed $700 billion since some types of loans were not included in the OECD total which he cited.[19]

The top seven debtor countries (which includes the Philippines), account for $205 billion of the more than $500 billion in private bank loans. Requests for rescheduling of debt payments are increasing.[20]

In April 1983, the financial world was worried about the mounting debt of Latin America LDCs. Its massive $300 billion in foreign debt is accounted for by only seven nations: Mexico, Brazil, Venezuela, Argentina, Chile, Peru and Columbia.[21]

On the Philippine front in the meantime, the country was rocked by a BOP deficit of $1.135 billion, a trade deficit of $2.805 billion and a cash deficit of P14.4 billion.[22] It successfully negotiated for World bank and IMF loans to tide over the crisis. However, the IMF conditions were formidable: reduction of cash deficit to P9 billion, further restructuring of tariff rates and further devaluation of the peso. These severe conditions have elicited strong reactions from various sectors, including politicians.[23]

Finance and monetary officials have taken drastic measures to control levels of foreign borrowing and have imposed disciplinary measures on government agencies and public corporations.[24]

The various steps that are now taken by policy makers are laudable. However, it cannot be denied that Filipino writers have been warning against a debacle like this since the 1960's.

Wilkens has suggested the following conditions for overcoming the acute debt crisis of LDCs:

1. Close cooperation between banks, the debtor countries and the creditor nations;

2. Adequate financial means for the multilateral institutions, above all the IMF;

3. Readiness on the part of the debtor countries to restrict their rate of development and their consumption; and

4. Readiness of the creditor banks and creditor states to help the debtors overcome the temporary lack of liquidity.

He further warned that overly severe IMF conditions can be an overkill, thus: "The credit conditions of the IMF standby credits should be reviewed once again. But it would not be in the interest of the IMF member nations, neither those who pay nor those who receive the loans, if too strict conditions would result in overkill. Therefore the requirements of development policy should be taken into account to a greater degree. Short-term austerity

programmes, which frequently are a great political burden and which hinder social reforms, should be avoided. A relaxing of loan conditions seem especially appropriate in cases where structural balance-of-payments deficits cannot be eliminated even through major efforts on the part of the country in question.

Recent events have dramatized the issue of public borrowing. Perhaps it is really time to pause in the midst of our hectic "development" borrowing and spending and reexamine the concept of development as interpreted by LDCs. After all, borrowing is only part of development policy. The following questions still remain: Can LDCs afford the price development as currently interpreted? Can development goals be scaled down to suit our current affordability levels?

Finally, it must be clarified that the issue herein is not borrowing, per se. The issue here is borrowing as practised. To end this chapter, five questions which can perhaps be used as a guide in evaluating the current borrowing policy are posed:

1. For what are we borrowing? (massive, large-scale projects?)

2. From whom are we borrowing?

3. Under what conditions are we borrowing?

4. And most important of all: For whom are we borrowing? Who benefit from borrowing; The banks, industrialized countries, contractors, local elites, or the people?

ENDNOTES

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[11]Payer, *Ibid.*

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[18]Payer, The World Bank...pp. 19-20.

[19]Herbert Wilkens, External Debts of Developing Countries" in Development and Cooperation, (Berlin: German Foundation for International Development, No. 2, March-April 1983), p. 4.

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[21]"Another Latin Debt Crunch," Newsweek Magazine; April 4, 1983, p. 39.

[22]Laya, *op. cit.*

[23]"IMF Dictating Too Much on RP - Benedicto," Philippine Daily Express, April 15, 1983, p. 1.

[24]"Foreign Borrowings of Government Firms Curbed," Philippine Daily Express, April 14, 1983, p. 10.

A POSTSCRIPT

THE FOREIGN DEBT CRISIS: IS THERE A WAY OUT?

Introduction

Since 1983, when the country underwent a severe debt cisis that it had to declare a moratorium, to the ouster of the late President Marcos and the take over of the Aquino government in 1986 to the present, several policy changes occured although much of the policies on debt during the Marcos time were retained by the Aquino administration.

Prior to the early 1970s, the country's debt was primarily official since majority of creditors were foreign goverments and international financial institutions. Thus, most loans were on concessional terms (low interest) and were often extended for purposes of implementing development projects. However, in the late 1970s and early 1980s, commercial banks became active in international lending when "petrodollars" coming from the OPEC were in surplus. After several years of mostly unproductive spending, several developing countries, the Philippines included, ended up not being able to pay the rapidly growing debt and interest payments exacerbated by both external and internal phenomena. Many experienced severe "debt crisis" and stayed there even up to the present. This resulted in the reduction of commercial banks exposure since the Third World countries have become high risk debtors. The debtor countries then shifted back to official borrowing as reflected by the increasing share of ODAs (official development assistance) in the total debt. Although official debt is incurred on concessional terms, i.e., below market interest rates and longer repayment periods, it has its disadvantages. While bilateral debts have political as well as trade conditionalities, multilateral debts affect the country's whole economy, from trade to operations of government corporations and to fiscal and monetary policies.

Recently, the Philippine debt managers have been saying that the foreign debt problem is already "behind us" and that the country can now proceed to other pressing problems. Acting on instructions of the President which were transmitted through the Speaker, the House of Representatives voted against two debt relief measures: the Debt Cap bill and the bill repealing automatic appropriations of debt service. Again, the assumption was that the debt crisis is over and there is no need for debt relief.

Borrowing per se is not bad. Whether foreign or domestic, it can be a powerful tool for generating resources to finance sustainable human development. The present situation indicates that foreign debt has become unmanageable and has reached crisis proportions. Continued full servicing of the debt has resulted in a nightmarish situation where most of the resources of government is diverted to debt payments at the expense of economic and social development. An audit conducted by the Commission on Audit revealed that as of 1991, debt service for domestic and foreign debt accounted for 66.9% of the budget. The country is in a situation where debt has become a major constraint to development. The policies of government have not reversed the crisis. The economic managers merely transformed the composition of foreign debt and triggered the uncontrolled expansion of domestic debt.

I. The Philippine Experience with Foreign Debt

A. *What was the debt like from 1986-1992?*

Table 1 shows how the failed debt management policies of the government has resulted in a larger debt stock, and a predominance of official and multilateral debt. The policy of faithfully paying all debts, fraudulent or not, has ironically failed to reduce the total foreign debt stock of the country. At the end of 1986, foreign exchange liabilities stood at $28.256

billion. By 1992, it stood at $29.621 billion. Negative transfer of resources ranged from $1 billion to $2 billion annually.

What is even more alarming is how the foreign debt has been transformed by the country's debt managers. In 1986, commercial bank debts of $16.184 billion accounted for more than 50% of total foreign debt stock. A good number of these debts have been identified by the Freedom from Debt Coalition as fraudulent. Separate reports of the Commission on Audit, the Presidential Commission on Good Government and the Senate Blue Ribbon Committee identify a host of behest loans.

Since 1986, the government has been steadily paying for these commercial bank debts, including the fraudulent loans. Their most "innovative" schemes like the debt-buyback were financed by borrowings from the multilateral institutions, e.g. World Bank (WB), International Monetary Fund (IMF) and the Asian Development Bank (ADB). Since the commercial banks merely collected their pound of flesh but hardly lent new money, the economic managers shifted to more borrowings from bilateral lenders like Japan and the United States. In other words, the debt managers "reduced" the commercial bank debts by increasing our bilateral and multilateral debts!

By 1992, commercial bank debts went down by nearly half to $9.5 billion while official debt doubled from $8.613 billion to $17.170 billion.

The massive shift from commercial bank debts to official debt has worrisome implications. All loans have conditionalities. Those imposed by commercial banks are primarily financial: interest rates, spreads, periods of repayment, etc. Those imposed by bilateral lenders (country governments) tend to be related to political as well as trade conditionalities. Those imposed by multilaterals involve detailed participation of these institutions in development plans, and the entire gamut of economic policies ranging from trade, government corporations, to fiscal and monetary policy.

B. *What conclusions can be drawn from the 1986-1992 experience?*

1. It is clear that the foreign debt crisis is not yet over. The debt stock has increased, negative transfer of resources still persists, and official creditors with their onerous conditionalities now dominate the foreign debt scenario.

2. The pervasive burden of foreign debt has led to a much larger domestic debt. The stock of domestic debt stood at P118.4 billion in 1986; by 1991, this has already ballooned to P353.4 billion. Domestic borrowings were increased to buy foreign exchange to service the foreign debt. At the same time, domestic borrowings were also resorted to in order to compensate for the slack in commercial bank lending. Finally, the mopping up operations of the Central Bank which were implemented as IMF conditionalities forced the national government to go into massive borrowing, at excessive rates of interest.

3. The moral issues have not been addressed by the government. Fraudulent commercial bank loans, including the notorious Bataan Nuclear Power Plant (BNPP) loans have been converted into official debts through restructuring, buybacks and the like. In other words, government has recognized their legitimacy and makes no distinction between fraudulent and non- fraudulent debts.

4. The distribution of the foreign debt burden is most inequitable and unfair. Since most of these were transferred to the national government (NG) from the government owned and controlled corporations (GOCCS) like the National Power Corporation ,and government financial institutions like the Philippine National Bank and the Development Bank of the

Philippines, Mang Pandoy and millions of Filipinos like him are directly affected. This is because he depends on national government for basic services like health, education, and welfare. Table 2 clearly shows how expenditures for economic and social services have been greatly eroded even as the debt burden has increased.

5. Decisions on debt strategy and management were made primarily by the President, upon advice of the Department of Finance and the Central Bank. These institutions were under tremendous pressure from the creditor institutions particularly the bilaterals and multilaterals.

Claims have been made that democracy has been restored and democratic institutions revived. However, it is in the realm of economic policy, particularly debt management where democratic tenets were ruthlessly trampled on.

The Legislature was shut out of decisions concerning debt. This is particularly true for negotiations with the IMF. The situation is unfortunate because development programs inevitably include decisions which require legislative enactment like taxes, borrowing, and expenditures. The House of Representatives is not entirely blameless. By their refusal to repeal automatic appropriations for debt service in P.D. 1177, the Congressmen have allowed the Department of Finance to blatantly ignore the Constitution and give highest priority to debt. They have joined hands with the Executive in diminishing their "power of the purse."

Worse, the public was totally ignored in debt deliberations. "Consultations" were held by the Foreign Debt Council but the inputs from hundreds of NGOs and PVOs were not reflected in its final decisions. Critical public opinion on the government's handling of the foreign debt has been mounting since 1988. Independent surveys show as high as 80% awareness of the debt management. The lowest rating President Aquino received was for debt management. By the time she stepped down, her rating had gone from 22 points to -38 points.

It can safely be said that the management of the debt problem by both the Aquino and the Ramos administrations has been undemocratic and did not involve the participation of the people who are paying the debt, especially the poor.

C. *How will debt look like in 1997 and beyond?*

To have an idea as to how the debt will look like if government persists in its present policy, some projections of the World Bank are examined.

1) For the next five years, the foreign debt will increase drastically. The World Bank has projected that long-term debt will swell to $40.014 billion by 1997.

World Bank projections indicate that the foreign debt problem of the Philippines is far from resolved. By 1997, long term debt will rise to a staggering level of $40 billion. Foreign borrowings from 1992-1997 will total $20.356 billion. Amortizations and interest payments from 1992-1997 will total $24.214 billion, excluding payments to the IMF and payments for $6 billion in short-term loans. All these will be appropriated and paid out without consultations with Congress.

The World Bank has noted that the Philippines will require massive foreign borrowings to meet its financing requirements. In its own words, "the need to continue to rely heavily on foreign savings implies that the Philippines is still far from a full recovery from its debt crisis." From 1993-1997 the Philippines must mobilize approximately $5 billion annually. Of this, $3

billion is expected to be raised from additional official borrowings while the remaining $2 billion is still unsourced.

More than ever, the passage of the debt cap bill and the repeal of P.D. 1177 are necessary to screen the massive debt service payments projected up to 1997. As long as basic reforms to resolve the chronic financial crises of the country are not in place, powerful instruments like a debt cap are necessary to stanch the negative outflow of financial resources.

2) Actual debt service payments have been rising dramatically. In 1991 alone, total debt service comprised 66.9% of the national budget.

The public impression is that more than 44% of the national budget goes to the servicing the debt, both domestic and foreign. Actual figures are more shattering. In 1991, out of the original budget level submitted by the President to Congress totaling P254.4 billion, P170.1 billion or 66.9% went to debt servicing.

This figure means that in 1991, P170.1 billion did not pass through congressional scrutiny and review. To accommodate this amount, cuts were made on budget items already appropriated by Congress.

From 1986-1991, the average ratio of debt service to the annual budget averaged an all-time high of 52.8%, as indicated below:

Year	Annual Budget	Total Debt Service	Ratio to Annual Budget
	(amounts in billion pesos)		
1991	254.4*	170.1	66.9%
1990	211.8	128.4	60.6%
1989	224.7	99.3	44.2%
1988	190.7	71.2	37.3%
1987	160.4	118.4	73.8%
1986	118.8	40.6	34.2%
	Average Ratio of Debt Service to Annual Budget		52.8%

*Original budget level submitted by the President to Congress.

In the words of the Commission on Audit,

"For a poor country like the Philippines, spending P170.1 billion on principal and interest payments for one year alone is quite onerous. This amount could have been used either to:

1) feed some 200,000 refugees of Mt. Pinatubo for more than 23 years at P100 per person each day,

2) finance the 14-year Modernization Program of the entire Armed Forces of the Philippines with an estimated cost of P170 billion, or

3) fund the budgetary requirements to implement all the programs, projects and services of the government for one fiscal year, including agriculture, environment and natural resources, trade and industry, public works, transportation and communications, energy, irrigation, education, health, defense program and the general public services."

All these increases in debt servicing are occurring without the official concurrence of Congress precisely because these are automatically appropriated and the existing debt cap is not followed. Again, in the words of COA, "every year the cost of debt service grows steadily, averaging 17% or P22 billion. The biggest increases were recorded in 1987 and in 1991 amounting to P41 billion for each year."

In the light of the projections of the World Bank, it is likely that the debt service burden from 1993-1997 will reach stratospheric levels.

The need to closely monitor actual debt service payments is the strongest argument for a debt cap and the repeal of P.D. 1177. The situation where two branches of government are appropriating government expenditures: the executive for debt service, and the legislature for other expenditures is anomalous. The anomaly becomes intolerable when the automatic increase in debt service causes an automatic decrease in the productive appropriations made by Congress.

II. Is there a way out?

Considering the grim scenario presented, is there a way out of the foreign debt crisis? In this section, the views of the Freedom from Debt Coalition (FDC), which is the biggest people's organization concerned with the country's debt, is presented. The FDC has repeatedly pointed out that actually, there are several ways out of the crisis.

It is now 1993 -- eleven years since the global debt crisis exploded. Since then, international institutions like the United Nations and its agencies, religious organizations and their leaders, scholars and experts, NGOs and PVOs have proposed sustainable solutions to the foreign debt problem on a global scale.

The problem of the foreign debt is complex and many sided. It is more than a financial and technical problem ; it has strong economic, political and social implications. The moral implications of continued payment of fraudulent debt is a powerful justification for non-payment of these debts. Thus, the debt strategy of FDC addresses these various aspects.

A. *Reforming the legislative and policy framework for debt management*

The first step in initiating debt reforms is to change the legislative and policy framework. At present, the policy is to pay all the debts whether these are fraudulent or not, and beneficial or otherwise. Likewise, debt is automatically appropriated, thus depriving the Legislature,

particularly the House of Representatives, the right to exercise fully their Constitutional mandate on appropriations.

B. Acting on what is left of the commercial bank debts

During the Aquino administration, the commercial bank debts which originally constituted more than 50% of total foreign debt have steadily been reduced as official debt has increased.

FDC is calling for the non-payment of the behest loans which have already been identified by the Commission on Audit. In addition, it is calling for the non-payment of the six fraudulent loans which it originally identified, totaling approximately $3 billion. It is particularly campaigning for non-payment of the BNPP loans -- both commercial and EXIMBANK loans.

C. *Reducing bilateral debt, mainly through political/diplomatic negotiations.*

In recent times, the most dramatic reductions of debt were secured through political and diplomatic negotiations, as in the case of Poland, Egypt, Israel, the Sub-Saharan and Caribbean countries.

During the last G-7 meeting in Munich, four out of the seven member country governments were very sympathetic to substantial debt reduction even for middle-income countries like the Philippines. These are Canada, the United Kingdom, France and Germany.

NGOs in creditor countries are very powerful and effective pressure groups. They can be mobilized in negotiations with bilateral creditors. The EURODAD (European Network on Debt and Development), for example, is currently campaigning for creditor governments to write-off 50% of middle-income countries official debt. Other leading international NGOs have voiced support for this position. A group of international NGOs like OXFAM, Community Aid Abroad, Christian Aid, et al. is also circulating a petition asking the Paris Club to write-off 50% of the bilateral debt of the Philippines.

D. *Rescheduling multilateral debt and negotiating for relaxation of fiscal and monetary targets.*

The government's financial and economic team is currently under IMF pressure to renegotiate, justify and revise the targets and measures contained in the Medium-Term Development Plan (MTDP). We urge government to straighten its spine and negotiate for liberal fiscal and monetary targets so we can attend to the needs of our people.

Six economists from the University of the Philippines School of Economics have likewise urged the government to suspend negotiations with the IMF on a new economic program until after the MTDP has been reviewed, revised and accepted by Congress. They also called on leaders in the Executive, the Senate and the House to pay closer attention to the economic fundamentals and to invite various sectors of the public to participate in the process, and work out a common agenda for legislative and executive action, and a social compact among the sectors involved.

E. *Mobilizing support from the international community*

FDC does not claim originality for its minimum program. These were originated by United Nations organizations like the UNDP, UNICEF, UNESCO, UNCTAD and UNCHR.

These agencies have conducted detailed case studies on the debt issue. They are in the forefront of the debate with the multilaterals on the issue of human development.

The UNDP has consistently identified the global debt problem as a major constraint to genuine human development. It has called for reforms of the two largest multilateral institutions: the WB and the IMF. In its latest Human Development Report, the UNDP has called for substantial reduction in the debt burden of heavily- indebted countries.

As early as 1989, UNICEF has been calling for "adjustment with a human face". In its landmark publication of the same title, UNICEF categorically calls for selective debt disengagement from fraudulent loans and supports a debt cap. It has done an exhaustive case study on the Philippines. Only recently, UNICEF run a series of calls on television with the rallying cry, "tear up the debt."

UNESCO has been calling attention to the deteriorating condition of education in heavily-indebted countries like the Philippines. Three years ago, UNCTAD called for a 30% across the board reduction in commercial bank debt. UNCHR has called attention to the human rights dimension of the global debt crisis.

These organizations can be mobilized as powerful allies in negotiations for debt reforms.

Major religious organizations have called for a pro-people approach to the debt problem. FDC advocates mobilizing the support of major religious groups locally and abroad to put pressure on the creditor banks and countries. The influence of religious leaders can be a valuable input to diplomatic initiatives on debt.

F. Mobilizing the people for debt reforms

The Coalition vigorously advocates consultation with the people on the matter of debt policy. In the final analysis, it is the people who are paying the debt. They should be consulted on how the debt will be managed. Not only must they be consulted; they should be listened to. This is the essence of the democratic process.

G. *Reaching a consensus on sustainable human development*

Debt management policies merely reflect the overall development framework. The foreign debt crisis resulted from a distorted definition of development, misguided priorities and erroneous policies. All sectors must join hands to come to a consensus on the kind of development to aspire and work for -- a development which is sustainable and will allow human development to flourish; a development where debt will be an instrument for progress.

III. Concluding Remarks

Yes, there ARE ways out of the debt crisis! The most important ingredients are political will on the part of the leadership and democratic participation of the Filipinos, most of whom want a change not only in foreign debt policy but even more important in the national vision of development.

Table 1a. Distribution of Total Foreign Exchange Liabilities (In Percent)

Particulars	End-1986	Aug-1992
Total	100.00	100.00
1. By Debtor		
a) Public	51.91	64.84
b) Central Bank	25.34	13.69
c) Private	22.75	21.46
2. By Creditor		
a) Official	30.48	57.97
Multilateral	16.59	23.31
Bilateral	13.89	34.65
b) Commercial	57.28	32.07
c) Others	12.24	9.96
3. By Maturity		
a) Short-term	19.03	17.40
b) Medium- & Long-term	80.97	82.60

Table 1b. Total Foreign Exchange Liabilities (In Million US$)

Particulars	End-1986	Aug - 1992
Total	28256	29621
1. By Debtor		
a) Public	14668	19207
b) Central Bank	7161	4056
c) Private	6427	6358
2. By creditor		
a) Official	8613	17170
Multilateral	4688	6905
Bilateral	3925	10265
b) Commercial	16184	9500
Others	3459	2951
3. By maturity		
a) Short-term	5378	5155
b) Medium- & Long-term	22878	24466

Source: Central Bank

Table 2. Sectoral Allocation of National Government Expenditures (Average Shares)

A. Major Sectors (% Share)

	1981-1985	1986-1990	1986-1992
1. Economic Services	33.93	19.07	18.97
2. Social Services	19.86	18.53	19.29
3. General Public Services	13.33	9.08	9.52
4. Defense	13.24	9.55	9.60
5. Debt Burden	19.63	43.78	42.62

B. Debt Service and Essential Services (% share to total budget)

	1981-1985	1986-1990
1. Debt Burden	19.63	43.78
2. Agriculture, Agrarian Reform and Natural Resources	6.56	5.31
3. Power and Energy	2.99	1.12
4. Education, Culture and Manpower Dev't	12.89	12.74
5. Health	3.96	3.08
6. Land Distribution (CARP)	0.00	0.21
7. Housing and Community Dev't	2.21	0.51

Source of Basic Data: Department of Budget and Management

NOTES ON THE NATIONAL GOVERNMENT DOMESTIC DEBT

FDC POLICY ANALYSIS GROUP

I. BACKGROUND ON PUBLIC DEBT

1. Fiscal deficits, meaning the gap between government revenues and total expenditures, are prerequisites to accumulating public debt.

2. The gap actually represents the difference between government revenue generation and the desired level of spending of government. The absence of money to fully finance its desired spending prompts a government to borrow. This desire to borrow in order to spend more than one can afford are usually justified by the following:

   a. development finance - there are instances when government may need a very huge amount to give the economy the push for growth. There are development projects (infrastructures, etc.) which government will not be able to afford unless it borrows. An assumption here is that the projected returns from the projects outweigh the cost of borrowing.

   b. cheap credit - there are times when interest rates are very low that many projects financed through borrowing appear economically viable.

   c. financing current expenditure - government perceives a need to increase consumption which it does by increasing consumer subsidies and public sector wages and employment through borrowing.

Both current expenditure finance as well as development finance are related to the political ends of government.

3. There are several ways of financing expenditure gaps:

   a. raising taxes - tax revenue constitutes the main source of government spending. When a government wishes to spend more, it will have to raise taxes. In an underdeveloped nation like the Philippines, however, there are constraints to the drastic increase in taxes. These include political considerations, low real incomes of the population, protected status of the small economic elite who can afford tax increases, and corruption which impacts on tax administration and collection.

   b. tapping domestic savings - this is actually domestic borrowing. Under normal conditions, this is also limited in the third world. The constraints include the absence of an expansive domestic capital market, government aversion to possible crowding-out of private investment, the promotion of low-interest rate macro-economic policy, and the risk to lending to government perceived by the creditors especially in times of political instability.

   c. monetary expansion - Government may choose to finance its additional expenditures through the creation of money. There is however the fear of inflationary pressure brought about by money supply expansion especially when production could not effectively keep-up with demand.

d. foreign borrowing - since there are constraints to using the first three options in financing expenditure gaps, foreign borrowing has been the favored source of deficit financing when available.

II. SOME HISTORY: HOW THE HUGE DOMESTIC DEBT CAME TO BE

Table I
How government financed its borrowing requirements
1975 - 1988

	borrowing requirement (P Million)	% Total	Net Foreign borrowings %	Net Domestic Borrowings %	Monetary CB (%)	System Banks (%)	Domestic Non-Banks %
1975	3,460	100	39.9	64.1	65.0	50.1	-51.1
1976	12,505	100	14.4	85.6	9.6	-0.7	76.6
1977	10,202	100	66.0	34.0	5.1	6.0	22.9
1978	7,496	100	98.8	1.2	0.8	0.1	0.3
1979	7,384	100	106.1	-6.1	-11.3	-7.8	13.1
1980	11,541	100	57.7	42.3	10.4	6.0	25.9
1981	22,107	100	34.2	65.8	15.0	1.6	49.2
1982	18,844	100	72.9	27.1	17.7	23.1	-013.7
1983	11,549	100	100.2	-0.2	29.0	15.1	-44.3
1984	18,769	100	81.2	18.8	-27.1	28.9	17.0
1985	15,707	100	-16.5	116.5	58.2	-28.4	86.6
1986	26,355	100	-6.5	106.5	-31.5	9.2	128.8
1987	14,900	100	44.3	55.7	-247.7	6.0	297.3
1988	17,197	100	3.5	96.5	-65.7	62.8	99.5

Source: PIDS

1. Table 1 shows how government financed its borrowing requirements.

Net foreign borrowings represent the principal flows of foreign finance. This is the net amount after subtracting amortization from new borrowing. It is measured here in terms of its percentage share to financing the borrowing requirement.

Net domestic borrowing represents the share of principal flows from domestic sources in financing borrowing requirement. Domestic borrowing comes from the CB and other bans, as well as domestic non-bans.

2. We see from the data a heavy reliance on foreign borrowings from 1975 to 1984, averaging 66.7% of all government borrowing requirement. Foreign loans were available at low interest rates. These loans enable the Marcos government to spend more than what it may possibly raise from domestic sources. It is now common knowledge that a large part of these debt were either not used wisely or used for personal economic interests.

3. For the same period (1975-1984), the government was sourcing 33% of its borrowing requirement from domestic finances. Looking at the breakdown of domestic borrowing, we see that the CB figures prominently in financing government deficits. This means that government has been financing part of its deficit

through money creation. The private sector has also been tapped to finance government spending. But in certain years such as in 1975, government even intermediated finance for the private sector. Government borrowed more than its deficit requirement to finance a demand by the private sector for capital.

4. There was a sharp change in the borrowing situation beginning 1985. There were principal outflows in foreign financing in 1985 and 1986. From 1985 - 1988, foreign financing accounted for a mere 6% share in financing borrowing requirements. Obviously, heavy domestic borrowing compensated for the shortfall.

But the domestic borrowing distribution reveals even more. In 1986 to 1988, government borrowed heavily from the private sector (domestic non-banks) only to extend a large portion of these amounts to the CB. Right now, there are some P100 billion deposited by the national government with the CB. This deposit earns very low if not zero interest. From such transactions, government lost an estimated P20 billion yearly beginning 1986.

Why borrow more than the financing requirement? This is because government was not only thinking of financing budget deficits, it was also thinking of the level of money supply. Government mops- up excess liquidity through treasury bills. Such strict adherence to money supply targets are imposed by the IMF. It should be recalled that these years marked the shift from commercial foreign borrowing to official borrowing tied to heavy conditionalities.

5. We should make distinction between borrowing during the 70's and borrowing during the 80's. In the 70's borrowing was resorted to in order to increase government expenditure in budget items other than debt service. In the 80's, however, the increase in borrowing requirements was brought about by increased debt burden which grew even bigger when government assumed private liabilities. Some of these private liabilities were guaranteed by government, some were not. Those which were not guaranteed by government were assumed presumably to maintain financial credit worthiness.

The Aquino regime was faced by the huge financial drain brought about by the large foreign claims in amortization and interest payments. And because the Aquino government upheld the debt policy of full repayment, government had to turn to other sources of finance to bridge the deficit. Government had to raise finance not anymore mainly to pay for development finance nor current expenditure finance but to pay for foreign loans.

Because proceeds from tax increases were not enough to meet the additional burden of debt, government had to turn to large domestic borrowings. Thus, national government domestic debt increased from less than P100 billion in 1984 to more than P300 billion in 1991.

III. THE PROBLEMS POSED BY DOMESTIC DEBT

1. Currently, government is feeling the debilitating impact of domestic debt burden on the budget. Just like the foreign debt, instead of being a source of finance, domestic debt has now become a major drain on government resources.

2. We see clearly from Table 2 that what we borrow are often not even sufficient to pay for debt service. In 1991, we had to augment from government hard-earned resources what we borrowed in order to meet debt service. This year, we had to resort to even larger domestic borrowing to finance an increase in foreign debt service, at a time when our financial managers claim success in foreign debt management. Next year will be even worse. We would have to dig very deep from our pockets to service both foreign and domestic debt. Without additional

revenues, government would have to cut even further on the already anemic budget programs in social and economic services. The cuts being taken are a sure formula for economic contraction.

3. The problems posed by public debt (both domestic and foreign) on the fiscal program are clear:

   a. There is a large fiscal constraint posed by the huge debt burden. Finances have to be raised to finance this burden, and new borrowings are resorted not to augment government expenditures but to pay for the debt burden.

   b. In most cases, government ends up foregoing priority expenditures in other budget items only to service the debt burden. What is worse, budget cuts are done in a sloppy manner. Wages are reduced instead of trimming down inefficiencies. Capital expenditures are reduced instead of current expenditures.

On the part of the public sector, hardest hit by misplaced priorities was economic services. While economic services averaged a 35% share in government budget from 1980-1985, this fell sharply to 19% in the 1986-1992 period. The share of debt service, on the other hand, increased sharply from an average 14.7% in the 1980- 1985 period to 37% in 1986-1992.

Table 2

National Government Debt Expenditures,
1991 - 1993
(in million pesos)

Particulars	1991	1992	1993
Interest Payments	74,922	80,371	92,810
Domestic	56,347	57,738	71,796
Foreign	18,575	22,633	21,014
Principal Payments	45,504	38,952	33,675
Domestic	29,298	11,542	9,819
Foreign	16,206	27,410	23,856
Total	120,426	119,323	126,485
Domestic	85,645	69,280	81,615
Foreign	34,781	50,043	44,870

National Government Financing Program

Particulars	1991	1992	1993
Domestic Borrowing	64,722	110,849	32,235
Foreign Financing	23,086	23,440	27,540
Total	87,808	134,289	59,775

4. The heavy reliance on domestic borrowing has likewise resulted in other damaging distortions in the economy:

   a. Domestic borrowing pulls upwards domestic lending rates. The Philippines right now has a very high lending rate compared to its ASEAN neighbors (20% here compared to between 8-12% in other Asian countries).

   b. The people are paying for the earnings of a small domestic economic elite. The holdings of government securities are concentrated in a small financial group earning a big amount from high interest rates. The people pay in terms of budget cuts, high prices of goods, unemployment, etc.

   c. The current large domestic borrowing leads to a very wasteful crowding-out. Supposedly, the proceeds from borrowing are used for productive purposes. But borrowing to pay for the debt burden, a good portion of which are bad debts, is wasteful.

   d. The very high domestic interest rates has also overvalued the peso, negatively affecting exporters and promoting import dependence.

IV. Some Things To Do About The Domestic Debt

1. There is obviously a need to address the domestic debt problem. The economic managers said that they will now be relying more on foreign financing because of lower interest rates. But government needs to be more imaginative than this.

2. The domestic debt problem cannot be tackled exclusive of foreign debt. The foreign debt policy affects the options on the domestic debt front. For instance, government cannot monetize part of its domestic debt because it has to adhere to very tight monetary restrictions from the IMF, in turn tied to official debt being extended.

3. The following steps have to be taken:

   a. Foreign debt service has to be reduced. Reduction in foreign debt service means reduction in domestic borrowing.

   b. The government has to rethink its policy of strict adherence to IMF conditionalities. A relaxation in money supply ceilings will open other options to manage the domestic debt. A good portion of the domestic debt can be monetized provided that freed resources shall be used to address the expenditure backlogs of government. Top priority will be the power and energy sector. This production bottleneck has to be addressed to ensure that production can absorb money supply expansion and not result into a very high inflation.

c. Government has to shift to longer-term government issues to give it a cash-flow relief. The T-bills right now are of short- term maturities.

d. Government should broaden the base for government issues. Right now, only a small financial elite are able to avail of high-earning government securities.

e. Government should look into a negotiated approach on the settlement of domestic debt, especially with surplus-generating holders of government securities such as the GSIS and the SSS.

f. Government needs to increase its tax base. But this has to be progressive in nature, taxing those who can best afford.

CHAPTER 15

GLOBAL FINANCE STRUCTURES: IMPACT ON THE PHILIPPINE EXTERNAL DEBT

I. INTRODUCTION

II. COVERAGE OF THE PAPER

III. TRENDS IN PHILIPPINE EXTERNAL DEBT

- A. Growth Trends
- B. Debtor Trends
- C. Creditor Trends
- D. Debt Service Trends
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IV. IMPACT OF GLOBAL FINANCE STRUCTURE ON PHILIPPINE EXTERNAL DEBT

- A. Shift to ODA's (Official Development Assistance) from Commercial Bank Lending
- B. Increasing Debt Stocks
- C. The Need for More Loans to Finance Development in the Third World
- D. Debt Service and Elimination of Arrears
- E. The Socio-economic Impact of Debt, Debt Service and Debt-Induced Adjustment Programs
- F. The Changing Facet of Commercial Bank and Private Lending
- G. Voluntary Debt Reduction Schemes
- H. The Impact of Official Development Assistance on Balance of Payments

V. FRAUD IN INTERNATIONAL DEBT

VI. ISSUES AND PROBLEMS

CHANGING GLOBAL FINANCE STRUCTURES: IMPACT ON THE PHILIPPINES WITH REFERENCE TO ITS EXTERNAL DEBT*

I. INTRODUCTION

About a decade after the debt crisis exploded in 1982, the international finance community has already weathered its most crucial period. The commercial banks have effectively reduced their massive exposure to Third World Debt. Debt reduction schemes, supported by resources from multilateral and bilateral institutions were continuously applied to commercial bank debt. Debt restructuring and rescheduling of official and private debts were negotiated under the Paris Club and Bank Advisory Committees. New money packages were hammered out after sometimes long, drawn-out negotiations. Stabilization and adjustment programs overseen by the IMF and World bank served as the economic framework towards resolving the economic and financial crises which hit the international community in 1982.

From the point of view of the creditors and donors - the banks, foreign donor governments, multilateral institutions - the worst of the financial and debt crises is over. Global finance has already adjusted; the banks' profits and loss statements refurbished; their books insulated from further risks. Third World Debt jitters have ceased to dominate the limelight in global finance. Interest and attention have shifted to development assistance to Russia and new democracies in Europe like Poland and Germany. The end of the cold war signaled a policy shift from propping up democratic governments in strategic areas in Asia and Latin America as a countervailing force against communism/socialism to nurturing the growth of the new democracies in Russia and Europe.

Correspondingly, global finance is refocused towards trade initiatives, investment opportunities and other forms of economic cooperation with Russia and Europe. The opening up of new trade and investment frontiers and the trade implications of a one- Europe movement are the current concerns of Western finance.

Underlying US - Japan relations are these three basic issues in global finance - development assistance, trade and investments. In the race to gain or strengthen footholds in new and promising areas, global finance has channeled its efforts towards these areas.

This shift, as seen from the vantage of a Third World debtor like the Philippines, does not offer a solution to its development problem. In the first place, the debt crisis may have been eased from the viewpoint of the

creditors but it remains as real and burdensome for Third World debtors as it was ten years ago. The debt burden constricts growth in developing countries, more so now, when debt service continues to exert competing claims on resources while foreign financing for development projects have slowed down. Furthermore, adjustment and stabilization programs have adversely affected economic development and caused more poverty in debtor nations.

Thus, after the Baker plan and Brady initiative, the debt crisis is far from over for the Third World debtors. Starting in 1984, net transfers on long-term lending, i.e., net availments/amortization on long-term debt less actual interest payments, has been negative for indebted countries. During the late eighties, negative resource transfers reached an obscene level $50 billion annually - the debtors paying more than they received in terms of loans and development assistance.

Moreover, the drive towards increasing assistance to and trade with Russia, Poland and other budding democracies in Europe reduces resources and opportunities available to Third World heavily indebted countries. With commercial banks wary of providing more new money, the sphere for official development assistance from U.S., Japan and developed nations have widened, spreading available resources thinly among the long-suffering debtor nations as new democracies compete for these scarce resources. The political influence and motive in diverting resources to these new democracies is more compelling than the development needs of Third World debtor nations like the Philippines. This significant shift in global finance need to be recognized and its implications faced in the emerging international order and finance structure.

II. COVERAGE

The chapter dwells on the social and economic implications on the Philippines of global finance structure and its shifts. Since the most pervasive effects of global finance on the Philippines is on its external debt, the focus will be on the structure and effects of Philippine external debt. Shifts in global finance are reflected almost immediately on the structure of and approaches to the external debt.

As one of the many Third World debtors, Philippine debt strategies faithfully follow directions set by trends in global finance. While it is most affected by changes in global finance structure, the Philippines is not significant enough to influence course of events in the world financial environment. Like many small, open and highly-indebted economies, the Philippines is vulnerable to external forces but can not, on its own, chart or influence policies and directions set by international financial institutions,

foreign governments and other players in the financial and banking system. In fact, it is subject to changing directions in global finance to the extent that its growth and economic development depend on whether world conditions are conducive or responsive to its needs and problems.

Other variables in global finance like trade and investment also impact on Philippine trade and investment. It must, however, be stressed that trade and investment conditions in the Philippines can not be detached from their relationship with the external debt. Trends in trade, for example, mirror trends in external debt primarily because external debt or foreign financing are used to close the country's financing gap brought about by import-dependence and a large debt service burden.

Likewise, investments in the Philippines -- both foreign and local -- depend to a great extent on external debt. Foreign resources coming into the country in the form of foreign loans and assistance partly determine whether investments will be forthcoming or not. Under a debt-equity conversion program, investments are linked to external debt. Also, investments in the Philippines have to be induced by closing the external financing gap through compensatory or balance-of-payments loans with the International Monetary Fund and bilateral creditors.

Thus, the impact of global finance structure on the Philippines can best be illustrated by an analysis of Philippine external debt. The effect of external debt pervades every aspect of economic activity in the Philippines. Monetary and fiscal policies hinge on the external debt strategy adopted by the country's economic and financial managers. External debt remains a limiting factor to growth and development in the Philippines.

III. TRENDS IN PHILIPPINE EXTERNAL DEBT

A. *Growth Trends*

For the span of more than two decades, external debt accumulation in the Philippines is characterized by an accelerating trend. In 1970, it was recorded at $2.3 billion or 33.9% of Gross National Product (GNP). These are monetary and non-monetary liabilities incurred by both the public and the private sector from foreign entities such as the commercial banks, the multilateral organizations, the International Monetary Fund, the private bond market, foreign government and bilateral agencies, and other foreign institutions.

Philippine external debt rose quickly from $2.7 billion in 1972 to $24.82 billion in 1982 -- an increase of almost nine times its 1972 level, posting an average annual growth rate of 25% from 1972 to 1982 (See Table 1). This

illustrates the policy of development financing during the period -- a policy where development projects were financed by borrowings from external sources, particularly from the international financial system which was awash with recycled petrodollars. This was also the period when massive capital flight took place leading to the financial and economic crises in 1983 resulting from the unsettling political and social events prevailing at the time. This was manifested in a debt crisis where the Philippines had to declare a series of moratoria on debt service payments starting October 1983.

By the end of 1983, external debt of the Philippines amounted to $24.82 billion. It rose to $26.25 billion in 1985 -- an increase of $1.43 billion in a span of two years. This was accounted for mainly by capitalized interest on debt service payments after the moratoria and by foreign exchange fluctuations. Under the first and second rounds of Paris Club reschedulings (rescheduling of bilateral or government-to- government debts), portions of interest on maturing debt (60% in the first and 70% in the second) were capitalized and similarly rescheduled. Capitalized interest aggregated $542 million as of October 31, 1985.

The end-1986 external debt of $28.25 billion was 93.8% of GNP for that year and debt service for the same year claimed 41.6% of total external receipts before debt rescheduling.

Consideration of external debt in the Philippines is oftentimes divided into two -- from the 1970s to 1985 during the Marcos years and the period covered by the Aquino administration since February 28, 1986.

Table 2 clearly shows the changes in external debt since February 28, 1986 until end-1989. Increases in external debt were largely accounted for by net availment of foreign loans and credits, by capitalized interest on restructured debt and by adjustments for foreign exchange rate fluctuations. Revaluation adjustments are undertaken on foreign obligations denominated in currencies other than the U.S. dollar as in the yen and European currencies. Appreciation of these currencies against the dollar increases dollar values of outstanding external debts.

Thus, the bulk of the $1.914 billion increase in external debt from February 28 to December 31, 1986 can be traced to the $1.393 billion increase due to foreign exchange adjustments, the $941 million net availment of foreign liabilities, the $208 million capitalized interest less some $628 million reductions.

It was after 1986 that decreases due to debt reduction schemes were significant -- $931 million in 1987, $487 million in 1988, $1.658 billion in 1989; however, these were also offset by larger amounts of net availments, and significant amounts of capitalized interest and foreign exchange adjust-

ments. This characterizes changes in Philippine external debt -- debt reduction is offset by net loan availments because more foreign loans are needed to fuel development and to raise resources primarily for debt buy-backs and other debt reduction schemes.

As of end-July 1991, Philippine external debt stood at $28.8 billion -- an increase of $2.458 billion from the February 1986 level. Projections show that debt stocks could hit $32.2 billion in 1992 and $34.1 billion in 1993.

B. *Debtor Trends*

Philippine external debt consists mainly of two types of debtors: the public and the private sector. The public sector includes mainly the National Government, the Government-Owned or Controlled Corporations, and the Central Bank.

Private sector external debt was traditionally larger than the public sector debt before 1972. In 1970, public sector external debt stood at $1.07 billion or 46% of total. However, public sector share steadily increased after 1970 such that in 1983, the public sector accounted for $16.7 billion or 67.4% of total external debt (See Table 3). This reflects the prevailing policy during the Marcos years where the government appropriated for itself resources tapped from foreign sources for and in the name of economic development. Public sector share continued to accelerate to $19.12 billion in 1985 and $21.83 billion in 1986, accounting for 72.8% and 77.2% of total, respectively for the same years.

Of the $28.256 billion Philippine external debt in 1986, $21.83 billion is owed by the public sector, of which the National Government accounted for $6.5 billion in direct loans while the balance was incurred by other public sector obligators directly or through guarantees. The succeeding years saw a sharp rise in National Government external debt as the external liabilities of the Philippine National Bank (PNB), Development Bank of the Philippines (DBP) and the Philippine Nuclear Power Plant (PNPP) were assumed by the National Government. Thus, 1n 1987, 1988 and 1989, National Government external debt rose to $11.303 billion, $11.639 billion and $11.907 billion, respectively.

This explains the continued climb of public sector share of Philippine external debt in the same years. In 1987, 1988 and 1989, public sector debts posted at $22.8 billion or 79.4% of total, $22.67 billion or 81.2% of total, and $22.22 billion or 80.5% of total, respectively.

The acceleration of public sector external debt in relation to private sector after 1983 can be attributed to the assumption by the National

Government of publicly guaranteed private loans, majority of which were behest loans of the PNB, DBP National Development Company (NDC), and Philguarantee, among others. Furthermore, in accordance with several Debt Repayment programs of the government (under Central Bank Circulars 1081, 1091, 1138 and 1139), the Central Bank assumed private sector obligations upon payment to the Central Bank of the peso equivalent of these loans.

As of end - July 1991, public sector external debt registered at $23.07 billion or 80.2% of total. It can thus be said that the public sector has sustained its majority share of the external debt and will continue to do so. In the light of developments of the international financial and aid system where the Philippines has not reentered the mainstream of voluntary lending from the commercial banks and competition for development assistance from Russia and new democracies in Europe has grown stiffer, the trend is seen to continue. As foreign resources remain scarce, the public sector will foreseeably be given priority in foreign funding for development projects.

C. *Creditor Trends*

Philippine major creditors include the private commercial banks and financial institutions, and the official creditors consisting of multilateral and bilateral agencies and foreign governments.

Foreign commercial creditors have played a major role in Philippine external debt through their lending policies since the 1970s. Until 1983, debts owed to private commercial banks totaled $14.671 billion, to private suppliers $2.855 billion, and to private financial institutions $1.015 billion. These consisted of 59.12%, 11.51% and 4.09% of Philippine external debt, respectively. (See Table 4) In effect, in 1983 when the debt crisis exploded, Philippine external debt was largely sourced from private financial institutions primarily the commercial banks. The terms of the debt were then commercial in nature; hence its effects and implications were viewed as commercial transactions.

Official creditors constituted a combined share of 24.71% of 1983 external debt of $4 billion around 16.1% were accounted for by multilateral institutions like the World Bank, Asian Development Bank and International Monetary Fund. The remaining $2.138 billion or 8.61% were from bilateral sources, the biggest of which were Japan, the U.S. and export credit agencies.

The share of private/commercial creditors was gradually reduced as a response to the international debt crisis. The commercial debts, in particular, sought to reduce their exposure to the Philippines as part of a general strategy and reaction to the world debt crisis. By end-1988, the commercial

banks managed to trim down their exposure to Philippine external debt to $13.245 billion or 47.45% of total. Private suppliers and financial institutions likewise decreased their share to $2.111 billion and $396 million or 7.56% and 1.42% to total, respectively.

On the other hand, the multilaterals increased lending to the Philippines to $5.069 billion or 18.16% of 1983 total debt. Bilateral loans posted the highest increase to $6.509 billion, expanding their share to 23.32%.

As of end-July 1991, debt from multilateral and bilateral sources already reached $14.965 billion for a combined share of 52%. Commercial banks and financial institutions account for $11.109 billion or 38.6% of total. This amount includes the 1985 and 1989 new money bonds of $925 million and $700 million, respectively floated by the Philippines with the commercial banks as primary takers.

D. *Debt Service Trends*

From 1970 - 1975, an annual average of $104 million in interest were paid on Philippine external debt. From 1976 - 1980, the average yearly interest burden rose to $313 million. By 1980, interest payments shot up to $1.491 billion, the biggest ever since the borrowing binge. This trend was sustained from 1981 to 1985 where interest payments averaged $1.773 billion a year, peaking in 1982 at $2.459 billion.

Principal repayments exhibited similar trends. Starting from a meager $262 million in 1970, principal payments on external debt benched up in the 1980s - accelerating from $681 million in 1980 to $1.042 billion in 1982. From 1983 - 1985, principal payments averaged $855 million a year.

It is worthy to note that debt service - interest plus principal repayments - started to accelerate in the 1980s. From 1980 to 1985, average yearly debt service reached $2.5 billion, peaking in 1982 at $3.5 billion.

For these periods, the share of interest payment was around 70% of debt service. It is important to stress that debt service payments accelerated because *both* interest and principal payments rose steeply. However, interest payments increased faster than principal payments during the period. This was largely the result of high interest rates prevailing during that period which affected loans carrying floating interest rates. Around 57% of Philippine debt then were loans carrying floating interest rates. LIBOR (London Inter-bank Offered Rates) averaged at 7.5% from 1970 - 1975 and 9.3% in 1976 - 1980. Largely due to the Mexican default in 1982, LIBOR average rose to 11.8% from 1981 to 1985.

In 1986, as the international financial system began to recover and LIBOR fell to 6%, interest payments correspondingly fell as a proportion of debt service. This is not to say that interest payments were reduced. On the contrary, interest payments rose to $2.006 billion in 1988 and $2.183 billion in 1989. But then, principal repayments increased faster after 1986 as commercial banks sought to reduce their exposure to Third World debt through various debt reduction refinancing schemes. This resulted to the sustained increase of total debt service of the Philippines but the share of interest payments was reduced to 50 - 60% of total.

Nominally, however, debt service of the Philippines never decreased. In 1986, total debt service was at $3.038 billion; in 1987, $3.613 billion; in 1988, $3.482 billion; in 1989, $3.364 billion; in 1990, $3.675 billion. Since 1986, therefore, the Philippines has shelled out a total of $17.172 billion in debt service on an average of $3.43 billion a year. The $17 billion total payments for interest and principal represent over 65% of our external debt in 1986. In spite of this, Philippine external debt stock increased.

As a percentage of exports of goods and services, debt service averaged 24% of exports of goods and services from 1970 - 1979. From 1980 - 1985, an average of 30.6% of Philippine export receipts went to debt service. In 1986 and 1987, this ratio went up to 34.5% and 38.5%, respectively. This reflected the constraining effects of debt service on growth. Philippine exports and the country's productive capacity can not keep pace with a heavy debt service burden. In 1988, debt service ratio was still high at 31.5%. This trend remained until 1991 in spite of a vigorous export campaign.

E. *Net Resource Transfer*

Net resource transfer measures the net flow of resources in a debtor - creditor relationship. This indicator consists of net availment/amortization made by the debtor to his creditors plus the interest payments on outstanding loans and credits. Thus, net resource transfer determines who benefits more from a relationship and by how much.

From 1986 to 1990, net resource transfers of the Philippines with its creditors averaged at negative $1.506 billion. (See Table 5) In other words, the Philippines paid more in interest and principal payments than it received in loan availments. It must be noted that while net principal availments were positive, this was more than offset by interest payments which averaged more than $2 billion a year for 1985 - 1990.

The negative net resource transfer to the Philippines is largely accounted for by the banks and financial institutions and to a lesser degree, the multilateral institutions. The bilateral creditors, mostly official develop-

ment assistance (ODA) donors, showed positive net transfers at an average of $210.8 million. Clearly, this could not compensate for the negative net transfers with the banks which averaged at $1.14 billion yearly.

IV. IMPACT OF GLOBAL FINANCE STRUCTURE ON PHILIPPINE EXTERNAL DEBT

A. *Shift to ODAs (Official Development Assistance) from Commercial Bank Lending*

The spate of commercial bank lending and suppliers credits in the 1970s induced Third World governments to undertake development projects through these financing schemes. The result was an acceleration of public sector debt sourced from private financial institutions under commercial terms.

The 1982 world debt and financial crises saw a literal drying up of voluntary lending from the commercial banks. As the commercial banks sought to reduce their exposure to developing country debt, debtor governments assumed private sector liabilities converting them to public sector debts. Moreover, official creditors -- the multilateral institutions, foreign governments and bilateral agencies -- took over the role of providing development funds.

This is borne out by the fact that since 1980, long-term debt of developing countries to official creditors more than tripled. In the first half of the 1980s, official lending grew pari passu with private lending. Since end-1984, the share of official creditors in total debt rose to 46% of total in 1990 from 32% in 1984.

This was exactly the trend in Philippine external debt during the period. The impact was adverse. The bunching up of maturities on commercial loans led to a series of moratoria on debt service. Principal and interest payments grew intolerable even as their magnitudes continued to rise.

In response to the perceived need for stabilization and adjustment, the multilateral and bilateral creditors imposed a set of conditionalities and policy programs in exchange for official development assistance and rescheduling packages. These had serious implications on the economic growth and poverty.

Furthermore, availability of official development assistance became more and more subject to political conditions and expediency as perceived by the donor governments. In effect, obtaining foreign funds depend largely

on maintaining close alliances and political/strategic alignments with foreign donor governments. Compelling political developments take precedence over the real need of debtors for foreign assistance.

As in the cancellation of 50% of Poland's $33 billion external debt, debt relief is largely anchored on political and strategic considerations. With no significant bargaining leverage, the Philippines do not stand to be granted substantial debt relief. With the shift in global priorities from Third World debtors to the new democracies in Russia and Europe, the Philippines will stand to lose much needed development assistance as these are diverted to these countries. Competition for official loans and grants will grow stiffer and the remaining scarce resources can not adequately meet the economic needs of Third World debtors. Especially after the end of the cold war, the Philippines does not command the strategic-ness which will afford it the opportunity for special treatment or an innovative approach to its debt problem.

B. *Increasing Debt Stocks*

As seen in the Philippine case, debt stock has not really decreased. In fact, it has increased. The increase can be traced to foreign exchange revaluation. Even with little new money and new loans coming into the economy, the debt continues to rise. This trend is true for all developing country debtors precisely because of the effect of the global finance structure on external debt. In 1990, total developing country debt was estimated at $1.341 trillion, up from a level of $1.26 trillion in 1987, 1988 and 1989. This was brought about by the dollar's depreciation against other major currencies, increasing debt stock by 10% equivalent to $46 billion.

Global finance is structured such that movements in the exchange rates literally dictate trends in debt stocks. Between the end-1984 and end-1987, debt rose by $309 billion (about 11% annually), while between end-1987 and end-1989, debt actually declined slightly. The difference mainly lies in movements of the dollar vis-a-vis major currencies.

C. *The Need for More Loans to Finance Development in the Third World*

The sustained increase in debt stock of developing countries from $639 billion in 1980 to $1.341 billion in 1990 indicates the addiction of developing nations to debt financing. While funds from foreign sources have been reduced, demand is still strong in the face of large debt service and global recession. This is seen in the net flows of debt for the different periods. From 1985-1987, debt flows to Third World countries total $77.9 billion; from 1988-1989, $53.5 billion; and in 1990, $38.1 billion. While it has been proven that debt creates problems in servicing and economic growth, the

need to borrow again and in large amounts is more compelling as debtor nations struggle to survive.

The Philippines is no exception. From 1986 to 1990, estimated net loan availments amount to more than $3 billion. To finance development, to service its huge external debt, to close its financing gap due to a large import requirement, the Philippines' only recourse is to borrow. It had to seek IMF financing, in exchange for which it had to submit to a stringent economic stabilization program. The policy conditionalities therein were also made the bases for official and commercial bank creditors to lend fresh funds to the Philippines. The economic and social costs of the stabilization program will be discussed in the succeeding sections.

D. *Debt Service and Elimination of Arrears*

The primary concern of global finance since the debt crisis started was (and still is) to ensure that debtor countries continue to service their debts. A necessary condition for the IMF's seal of good housekeeping and the inflow fresh lending is the elimination of interest and principal arrears. This is to protect the creditors, mostly the commercial banks, from undue losses resulting from arrears on outstanding maturities. The purpose of the Baker Plan is the provision of fresh money so as to ensure continued debt service. The Baker Plan also provided a breathing space for commercial banks to strengthen themselves through higher reserves and capital increases. It did not however increase commercial banks' desire to resume lending on a significant scale.

The policy of global finance to favor the creditors and reduce the risk to the international financial system created an adverse impact on the interest of the debtors. The figures on net resource transfers is proof enough. The main beneficiaries of the present debt strategy so far have been the creditor banks and institutions. Abetted by the multilateral institutions notably the IMF through adjustment and stabilization programs, the central concern of balancing the external accounts of the debtors, i.e. ensuring resources for the payment of debt service and imports have been achieved to the interest of the creditors and donor governments at tremendous social and human costs in the debtor countries.

This global phenomenon is replicated in the Philippine case. As long as the Philippines persists in honoring all its debts and religiously servicing its debts, net resource transfers with the commercial banks will be chronically negative.

E. *The Socio-economic Impact of Debt, Debt Service and Debt-Induced Adjustment Programs*

Even as indebted countries persevered in faithful compliance to IMF and loan covenants, it is now conceded that they are no better off than in 1982 at the start of the global debt crisis.

The Philippine experience is a case in point. The national budget for fiscal year 1990 is virtually designed to adjust Philippine priorities to the requirements of global finance. It sets debt service as a primary concern. The debt service burden is guaranteed by the automatic appropriations for debt service in the national budget. Thus, from a low 5.2% average share of debt service of the national budget in 1972-1979, it rose to 17.1% in 1980-1985, to a high of 42% in 1986-1989. In the 1990s, it declined to about 30%.

It may be argued that less than half of total debt service in the national budget goes to servicing external debt, the greater share being that of domestic debt service. But an inextricable relationship exists between domestic and external debt in the Philippines. The government has resorted to domestic borrowings to compensate for foreign debt service. The flotation of high-yielding Treasury bills was also used as instrument against foreign exchange speculation due to low dollar reserves. Low dollar reserves are precisely caused by a burgeoning external financing gap due to heavy debt service and import-dependence.

Diverting expenditures to debt service implies heavy opportunity costs to other competing claims on national budget, notably social services such as health, housing and social welfare. Here, we focus on financing of health programs. Firstly, it must be stressed that spending on health care has been quite small. National expenditures on health in 1985, for instance, was P14.5 billion, equivalent to 2.4% of Gross National Product. This is less than half the World Health Organization- recommended 5% of Gross National Product. In the 1990 budget, the share of health expenditures will comprise around 3.3% as against more than 30% for debt service. It is estimated that transferring just 5% of the 1990 debt service allocation to health will more than double the budget of the Department of Health.

Over the years, the proportion of health expenditures to national budget exhibited an inverse relationship with that of debt service. From 1972-1979, health expenditures accounted for 3.9% of national budget; from 1980-1985, the meager share declined to 3.4%. By 1986-1989, this plunged further to 3.2%.

Based on the most conservative estimate of John Cavanagh and Robin Broad in their dramatic study, "Repaying the Debt Kills One Filipino Child

Per Hour", at least 9,200 children could be saved in a year if the Philippines would limit debt service payments to 20% of export earnings. In other words, 25 children a day could be saved, or more than a child per hour.

The debt problem faced by Third World nations are primarily the reason why resort to IMF facilities has been increasing. Unfortunately, the use of these facilities entail submitting to the IMF stabilization and adjustment "recommendations". As an overseer of the creditors' interest in ensuring structural adjustment and stabilization in debtor nations, the IMF and World Bank have proven to be very efficient partners. From the viewpoint however of the debtors, these programs and packages meant more sufferings and economic hardship.

Since the 1970s , the Philippines was placed under more than twenty economic stabilization/adjustment programs. Between 1971 and 1985, poverty rates shot up. Rural poverty climbed from 56% in 1971 to 64% in 1985. Urban poverty registered an even bigger increase, from 38% to 56%.

The impact of adjustment and stabilization programs are well documented. A case study by UNICEF on the Philippines form part of its now world famous book, "Adjustment With a Human Face". The study documents severe reduction in household incomes and consumption, reduction in government expenditure and corresponding social consequences such as deteriorating health, nutrition and housing conditions as results of adjustment programs. A study conducted by World Bank and IMF researchers noted that "Clearly, the macroeconomic adjustment in the Philippines in the 1980s adversely affected the poor, mainly through the increase in underemployment that followed the stabilization program." A major finding stated that during 1980- 1986, families in the lowest 30% income bracket received, an average 6.3% of total national income; while those in the highest 10% income bracket 44.6%. Through the debt crisis, the effect of global finance on the developing debtor countries is to exacerbate economic and social inequities as well as lower the overall quality of life in these countries.

F. *The Changing Facet of Commercial Bank and Private Lending*

Hardest hit by the debt crisis in its initial stages were the commercial banks and private lenders. This posed a big danger to global finance. Through a series of restructuring and rescheduling packages and a number of initiatives such as the Baker Plan and the Brady Initiative, the commercial banks have now recovered.

Until the present, they have continued to limit, if not reduce their exposure to developing country debt. For example, U.S. banks, which have provided a substantial fraction of developing country loans, actually have less cross-border claims of all kinds today than in 1983.

Lending to developing countries have ceased to be profitable as secondary market prices for developing country debt sharply declined. Provisions for loan losses attached to Third World debt also discourage commercial bank lending. Moreover, high returns are being offered in other financial transactions. Industrial countries offer attractive interest rates to finance their own government deficits. "Junk" bonds and leveraged buy- outs offered banks high returns for a time. Direct lending are thus avoided by banks as much as possible. They have shifted their portfolio to fee-based activities and "securitization" of loans.

The Philippines is no exception with respect to this strategy by the commercial banks. The 1989 new money package with the commercial banks consisted of new money bonds which are non-restructurable and auctioned to participating banks. The 1991 new money package involved the "securitization" of the new money provided in the 1987 debt accord. Securitization also included the debt papers of the nuclear power plant, a loan project which is heavily tainted with fraud. The direct impact of securitization is to give the loans "a fresh start" in the books of the banks, thereby giving them a clean image.

The current trend in world finance is for the banks to "get out" of developing country debt. The Brady initiative, while paving the way for voluntary debt reduction schemes, offered the commercial banks an alternative to direct lending and a vehicle to reduce their exposure to developing country debt. The Philippines, one of the first recipients of the Brady initiative, undertook a debt buy-back operation on commercial bank debt to the tune of $1.3 billion. It however had to shell out $650 million in cash for the buy-back, purchasing the debt papers at 50 cents to a dollar.

G. *Voluntary Debt Reduction Schemes*

Global finance has come up with a menu of debt reduction schemes, mostly voluntary debt reduction of commercial bank debts. More popular are the debt-equity conversion program, debt for asset swap, debt buy-back, and debt for note/debt swap. Clearly the debt equity conversion program links the debt to investments in developing countries. It offers a high premium to foreign investors -- the magnitude of the discount on the debt papers -- in investments to Third World nations. The debt problem faced by these nations then became avenues for foreign investors to avail of the resources and opportunities in these countries. Furthermore, the potential danger posed by this scheme on profit remittances continue to be unresolved.

Debt-for-asset swaps involve direct swap of debt for assets to be privatized or assets held by public sector. These privatization swaps dovetail

the policy thrusts contained in the adjustment/stabilization packages of the IMF and World Bank.

Debt-for-Note/Debt swaps allow the purchase of debt papers at a discount in exchange for their face value in local currency in the form of domestic debt or notes. Schemes of this type have a highly inflationary effect aside from increasing the burden of domestic debt service of the government.

The Philippines has reduced around $3.4 billion of external debt through the above-mentioned schemes, including its debt buyback of $1.6 billion. It is important to stress that while these voluntary debt reductions schemes may ease cash flow payments, they are clearly inadequate to reduce overall debt stocks. Furthermore, these schemes are expensive and require foreign exchange resources to implement. For example, the cash buyback of $1.3 billion had to be supported by an official loan of $650 million from multilateral and bilateral creditors as the Philippines did not have the reserves to support the buyback. Thus, what was gained in reduction of commercial bank debt was lost in terms of an increase in offical loans.

Furthermore, debt-equity programs and other debt schemes similarly create undue inflationary pressure. These also link the debt problem to investments in debtor economies like the Philippines. As scarce capital deter local investors, the premium enjoyed by investors in debt equity programs and debt-for-note/debt programs favor foreign investors and accords them opportunity to avail of the assets/resources in the economy at "sweetheart" prices. The hold of transnationals in key industries and sectors of the Philippine economy remains a raging issue. In the medium and long term, the pressure of foreign exchange reserves brought about by profit remittances will also have to be addressed.

H. *The Impact of Official Development Assistance on Balance of Payments*

The shift in the character of Philippine external debt from commercial and private lending to official lending reflect the overall trend with respect to developing country debt. In the Philippines, official development assistance or ODA has played an important part in development finance. The Philippine Assistance Program or PAP is a financial assistance package for the Philippines primarily consisting of ODA loans and grants to finance public sector projects on power, water, industry, infrastructure, agriculture, science and technology, etc. The PAP secured a total of $2.9 billion of pledges in 1989 and $3.2 billion in 1991. It is noteworthy to observe that 40% of ODA pledges came from Japan.

The issue of aid-tying, particularly with ODA loans and grants, have to be resolved. A NEDA study of ODA loans and grants to the Philippines

showed that flowback of ODA loans and grants to the donor countries range from 30 cents to 90 cents to a dollar depending on the type of assistance. This is traced to the practice of tying ODA utilization to the procurement of equipment and consultancy services to the donor country or to a group of countries. Bidding requirements and project specifications usually favored the contractors from donor countries, especially if the projects are undertaken on a turnkey basis.

Thus, ODAs serve as a vehicle by which trade and investment of the donor countries are expanded. The impact on the balance of payments of the debtor country is large. While the debtor copes with debt service, he also has to face a large import bill as official debt piles up. Foreign resources inflow to close the external financing gap goes out by way of imports arising from ODA loans, over and above debt service on these loans.

V. FRAUD IN INTERNATIONAL DEBT

Financing development projects in the Third World involved the key players in global finance -- the commercial banks, the suppliers and contractors, the multilateral and bilateral institutions. Until the 1980s, development finance was a lucrative business. With the support of debtor governments, lending to Third World countries led to the transnationalization of capital and finance. Whether through design or not, however, one of the effects of this trend in global finance is also to transnationalize fraud on a massive scale.

In the Philippines, this is illustrated in the case of the nuclear power plant loan. Around $2.2 billion in debt was incurred for the nuclear power plant. Undertaken during the Marcos regime, the nuclear plant project was heavily tainted with fraud right at the start. Due to the policy of "honoring all its debts", the Philippines continue to service the loans of the plant which was mothballed for technical and safety reasons. It continues to pay $300,000 a day in interest alone for a non- operations power plant.

VI. ISSUES AND PROBLEMS

A. The shift in priorities of global finance from Third World debt to budding democracies in Russia and Europe signals sharply reduced lending to other debtor economies. This will have serious impact on the economic development of debtor countries.

B. In the light of recent developments, new and innovative approaches to the debt problem have to be formulated. The debt crisis, as far as the debtor countries are concerned, remain as real and burdensome as ever. The search for lasting solutions is imperative.

C. The shift to ODA and official lending necessarily means a more "politicized" approach to the debt problem, in particular, and global finance, in general. Global finance is structured in such a way that debt can not be delinked from trade and investments, which in turn, can not be detached from compelling political and strategic motivations of developed countries and donor governments.

D. A new international economic order will have to recognize that the economic, social and human costs of external debt also have serious implications on global finance. Thus, shifts in global finance will have to take into consideration its impact on the debtor economies in real and financial terms.

E. There is as yet an undeveloped/dormant yet potent area for developing countries to play a key role in global finance. The transnationalization of the debt also means the effect of different debt strategies adopted by debtor governments will also be felt in a global scale.

F. In the light of the obvious marginalization of debtor countries like the Philippines in the shifting structure of global finance, it is important to enhance the effective role of international and national non-government organizations. Non- government organizations play a critical role in helping the poor of many indebted countries survive the brutal onslaught of global finance policies, in particular stabilization programs. They have gone beyond community development and grassroots organizations and are engaging national and international financial organizations in spirited policy debates. They have expanded their traditional roles to policy advocacy and action.

It is therefore important to further strengthen national and international NGOs in order to increase the bargaining power of indebted countries who are marginalized and left out of global decisions.

G. Finally, any campaign to strengthen the position of poor indebted countries like the Philippines viz-a-viz the colossal powers of the international financial institutions should include the mobilization of United Nations bodies. United Nations bodies like UNESCO, UNICEF, UNCTAD,and UNCHR have consistently criticized the solutions inflicted by international financial institutions upon hapless indebted countries. These solutions have solved the problems of global finance but not of the indebted countries themselves.

These UN bodies have documented in horrifying detail the human costs of these solutions.

Nevertheless, as shown by the experience of the Philippines, the views of these UN bodies are largely ignored. Heads of multilateral financial institutions like the World Bank and the IMF routinely go through the motions of requiring programs for poverty alleviation and the like. However, in terms of actual stabilization programs, the story has not changed. Specific programs required by these institutions have the effect of exacerbating poverty levels.

Steps need to be undertaken to increase the effectiveness of these UN bodies so they can prevail and put pressure on these imperturbable financial institutions. There is a clear need to go beyond expressions of concern and alarm on a global basis. We have to take a closer look at what is happening in these indebted countries and examine their stabilization programs. If we do, we will realize that nothing much has changed.

Table 1

PHILIPPINE EXTERNAL DEBT

YEAR	LEVEL ($M)	GROWTH
1970	2297	282.83
1971	2393	4.18
1972	2732	14.17
1973	2886	5.64
1974	3755	30.11
1975	4939	31.53
1976	6768	37.03
1977	8069	19.22
1978	10694	32.53
1979	13352	24.86
1980	17252	29.21
1981	20893	21.10
1982	24677	18.11
1983	24816	.56
1984	25418	2.43
1985	26252	3.28
1986	28256	7.63
1987	28649	1.39
1988	27915	-2.56
1989	27616	-1.07
1990	28535	3.33
1991 a/	28799	.93

a/ As of end July 1991.

Source of Basic Data: Central Bank

Table 2

CHANGES IN PHILIPPINE EXTERNAL DEBT
28 February 1986 to 31 December 1989
(In Million Dollars)

	FEB. 28.	D E C E M B E R			31,
BEGINNING BALANCE	1986	1986	1987	1988	1989
ADD/DEDUCT TRANSANCTIONS FOR THE YEAR:					
1. Regular Transactions - Net Availment (Net Payment)	941	(124)	411	986	1,729
2. Audit Adjustments OA/DA credits	(625)		(194)		
3. Debt reductions - thru:	(3)	(316)	(931)	(487)	(1,658)
a. Debt Equity Conversions	(3)	(259)	(648)	(91)	(92)
b. Debt for Debt Swap			(108)	(70)	(112)
c. Debt for Asset Swap				(132)	(2)
e. Debt Buy Back					(1,325)
f. Peso prepayment		(57)	(175)	(118)	(51)
g. Offset against Placement					(11)
4. Assignment of Credits to FCDU		(61)	(53)	(46)	(93)
5. Capitalied Interest of Restructuring Debt	208	195	127		510
6. Adjustment for FX rate fluctuations	1,393	699	(94)	(752)	594
TOTAL DEDUCTIONS/ (DEDUCTIONS)	1,914	393	(734)	(299)	1,082
ENDING BALANCE	28,256	28,649	27,915	27,616	28,698
	12/31/86	12/31/87	12/31/88	12/31/89	12/31/90

Source: Central Bank of the Philippines

Table 3

EXTERNAL DEBT OUTSTANDING OF THE PUBLIC SECTOR
(As of year end, in billion US $ and in %)

Year	Amount	% to Total
1965	.36	59.8
1970	1.07	49.9
1975	1.98	52.1
1980	6.77	53.3
1983	16.73	67.4
1984	17.55	69.0
1985	19.12	69.0
1986	21.83	77.2
1987	22.75	79.4
1988	22.67	81.2
1989	22.22	80.5
1991 a/	23.07	80.2

a/ As of July

*This includes the government commercial banks, CB and the public red clause advances

Source: Central Bank of the Philippines

Table 4

Philippine External Debt By Type of Creditors
As of end-December 1988
(In Million US Dollars)

Creditors	1983	1984	1985	1986	1987	1988
A. Official						
1. Multilateral	3396	4090	4486	4688	5033	5069
a. WB	2041	2215	2256	2297	2454	2526
b. IMF	1166	973	1232	1336	1342	1171
c.. ADB	693	799	885	943	1097	1228
d. Others	96	103	113	112	140	144
% of total	(16.10)	(16.09)	(17.09)	(16.59)	(17.57)	(18.16)
2. Bilateral	2138	2276	2860	3925	5203	6509
a. Japan	841	914	1273	1769	2487	3049
b. US	415	454	561	574	579	669
c. Export Credit Agencies	605	656	786	1332	1828	2398
d. Others	277	252	240	250	309	393
% of total	(8.61)	(8.95)	(10.89)	(13.89)	(18.16)	(23.32)
B. Private						
1. Banks	14671	14721	14474	15356	14824	13245
% of total	(59.12)	(57.92)	(55.13)	(54.35)	(51.74)	(47.45)
2. Suppliers Credit	2855	3103	3264	3085	2355	2111
% of total	(11.51)	(12.21)	(12.43)	(10.92)	(8.22)	(7.56)
3. Financial Institutions	1015	1089	795	828	390	396
% of total	(4.09)	(4.28)	(3.03)	(2.93)	(1.36)	(1.42)
4. Others	141	139	373	374	844	585
% of total	(.57)	(.55)	(1.42)	(1.32)	(2.95)	(2.10)
TOTAL	24816	25418	26252	28256	28649	27915

SOURCE: Financial Plan Data Center, Central Bank.

Table 5

NET RESOURCE TRANSFERS, 1986 - SEPTEMBER 1991 1/
(In Million US$)

PARTICULARS	1986	1987	1988	1989	1990	1991 p/
TOTAL	-1341	-1836	-1932	-1396	-1036	-324
Principal, net	747	271	236	1015	1118	1232
Interest	-2088	-2107	-2159	-2411	-2154	-1556
Banks and FIs	-826	-1222	-1079	-1448	-1129	-495
Principal, net	525	-37	-9	-65	-105	110
Interest	-1351	-1185	-1070	-1383	-1024	-605
Multilateral	-248	-476	-542	-48	-290	-47
Principal, net	127	-10	-13	443	273	425
Interest	-375	-466	-529	-491	-563	472
Others	-360	-401	-393	-129	5	-11
Principal, net	-230	-252	-308	-73	72	64
Interest	-130	-149	-85	-56	-67	-75
(% DISTRIBUTION)						
TOTAL	100.00	100.00	100.00	100.00	100.00	100.00
Banks and FIs	61.60	66.56	56.11	103.72	108.98	152.78
Multilateral	18.49	25.93	28.19	3.44	27.99	14.51
Bilateral	-6.94	-14.32	-4.73	-16.40	-36.49	-70.68
Others	26.85	21.84	20.44	9.24	-.48	3.40

MEMO ITEM:

Average (%)	1986 - Sept. 1991
Banks and FIs	91.62
Multilateral	19.76
Bilateral	-24.93
Others	13.55

1/ After rescheduling of principal payments, Jan. to Sept. 1991
p/ Preliminary

SOURCE: Central Bank

CHAPTER 16

THE IMPACT OF EXTERNAL DEBT AND ADJUSTMENT POLICIES ON THE REALIZATION OF THE RIGHT TO DEVELOPMENT AS A HUMAN RIGHT

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THE IMPACT OF EXTERNAL DEBT AND ADJUSTMENT POLICIES ON THE REALIZATION OF THE RIGHT TO DEVELOPMENT AS A HUMAN RIGHT

I. INTRODUCTION

During the decade of the eighties, three major issues occupied the attention of the world, particularly the developing countries. These are the issues of development, the global debt crisis, and human rights.

Using development models recommended by well-meaning multilateral institutions, aid-giving industrialized countries, and by their own foreign-trained nationals, developing countries struggled mightily but unsuccessfully with ever increasing levels of poverty. Because the problem of poverty remains unresolved and development goals have not been attained, more and more countries are questioning development models premised on increased levels of external borrowing, massive foreign investment, import liberalization, and other related economic policies. They are now engaged in efforts to work out development models which maximize the utilization of local resources, preserve the environment, reduce the intolerable debt burden, and directly confront the problem of poverty.

The decade of the eighties also saw the escalation of the global debt crisis to unmanageable proportions. Strategies recommended by creditor banks and creditor countries, notably the Baker Plan, and now the Brady Plan failed to staunch the continued negative outflow of resources from the indebted developing countries to the creditor institutions and countries. Even as these indebted countries willingly underwent harrowing adjustment programs at tremendous human and social cost, it is now conceded that they are no better off than in 1982 at the start of the global debt crisis. At the same time, the World Bank observed that "During the past three years, growth in the industrialized countries has actually exceeded earlier expectations." Thus, the decade of the eighties saw continued grinding poverty for indebted developing countries even as industrial countries experienced buoyant economic growth.

The persistence of the global debt crisis in spite of the plethora of "menus" and "options" which have been proposed and implemented at great human cost, clearly indicates that the crisis cannot be solved by impressive technical solutions directed at the debt problem exclusively. It is becoming

more obvious that the problems of external debt are clearly linked to economic policies and development strategies.

The decade of the eighties likewise saw intensified struggles of the peoples of many developing countries to evolve more democratic systems and assert national sovereignty in determining paths to development. This has brought about greater concern for human rights, both of nations and of individuals.

The experience of the developing countries during the decade of the eighties has explicitly shown that the issues of development, external debt, stabilization programs and human rights are closely interrelated.

The specific experiences of indebted developing countries indicate that models of development implemented by these countries constitute a major factor in the escalation of external debt to unmanageable proportions. The development models followed by many developing countries are premised on massive external borrowing as an indispensable component of "development finance". The values permeating concepts of development place premium on external borrowings as a *sine qua non* for development. It can therefore be safely stated that the models of development, the strategies for attaining development goals, and the proliferation of debt-financed "development projects" pushed developing countries to excessive, uncontrolled external borrowing which in turn triggered the global debt crisis.

On the other hand, adjustment policies which were undertaken by developing countries as part of their recovery programs proved disastrous to development goals and aspirations. If we take into consideration the United Nations definition of development where man is the object of development, and not its victim, it is obvious that adjustment programs, ironically had anti- developmental effects. As conceived and implemented, adjustment programs are targeted towards perceived problems in the economy. These are instruments of economic policy with very heavy social and human implications.

At the same time, adjustment policies as implemented by indebted developing countries had very serious human rights implications. These policies were implemented without public consultation. The sectors most affected were the poor, the marginalized, the women and children.

As the decade of the nineties commences, it is therefore most appropriate that a global consultation is being conducted on development as a human right, and related issues, among the most serious of which is the external debt.

II. THE GLOBAL DEBT CRISIS: A NEVER-ENDING STORY

Although the external debt problems of developing countries had been accelerating and worsening during the decade of the seventies, it is generally agreed that these reached unmanageable global proportions in 1982.

Since then, the debt crisis engulfed practically the entire continent of Latin America, a number of countries in Asia including the Philippines, Africa and even Europe. The crisis resulted from a combination of exogenous and domestic factors.

Among the exogenous factors was the tremendous pressure exerted on developing countries to expand levels of external borrowings. The seventies saw the growth of unregulated and uncontrolled money markets. Petrodollars deposited in European and US banks were relent to developing countries at very attractive interest rates. At the same time, governments of developing countries were attracted to grandiose development models demanding massive external financing.

While developing country governments were frenziedly putting up development projects financed from external borrowing, they were hit by a series of global shocks which pushed them to further borrowing. The first of these oil shocks were the higher oil prices in 1973-74 and 1979-80. These shocks automatically resulted in an increase of $260 billion in the external debt of non-oil developing countries from 1974-82. The second global shock which hit the hapless debtor countries was the escalation of interest rates in the United States, a major creditor country. At the height of the crisis, it has been estimated that a 1% increase in interest automatically resulted in an increase of $2.5 billion in interest for indebted developing countries. The third global shock which drove the debt-strapped countries deeper into debt was the worldwide recession from 1980-82. In 1981 alone, developing countries lost $79 billion in export volume.

What must be emphasized here is that the blame for the global debt crisis cannot be laid exclusively at the feet of debtor countries. Admittedly, they overborrowed and went overboard on their "development orgies". However, a substantial portion of their debts is accounted for by revaluations, escalating interest rates, the oil shocks, global recession, and other developments in the international financial environment which were beyond their control.

While the debt crisis is the result of overindulgence on the part of debtors and creditors, it is the debtor countries who are singlehandedly bearing the crushing weight of debt servicing.

In spite of efforts to contain it, the total external debt of the developing countries has been increasing. In 1985, it was recorded at $992 billion. By 1986, it had jumped to $1.035 trillion. In 1987, it was estimated at $1.190 trillion. By the end of 1988, it had reached $1.3 trillion--around 50% of the combined GNPs of developing countries.

It has been eight years since the start of the global debt crisis. Assessments by experts indicate that the threat to the international banking system has abated. One recurring fear which gave nightmares to creditors was the possibility of the collapse of the international banking system if major defaults of debtor countries would occur. This has been averted but at tremendous cost and sacrifice on the part of the debtor countries.

Yes, the international banking system was saved but the debt crisis continues. The industrialized countries continue to progress while the debtor countries continue to grovel in poverty.

Proposed solutions to the debt crisis have ranged from the traditional and cautious to the radical and confrontational. There has been no lack of "solutions" coming from the creditor countries and institutions, debtor countries, multilateral institutions, international agencies, non-government organizations, professionals, and concerned individuals. These efforts notwithstanding, the phenomenon of negative net resource transfer continues. This refers to the outflow of resources from the debtor countries to their creditors. In 1985, developing countries paid out $26.3 billion more than what they received from their creditors. In 1986, they paid $29 billion more. In 1988, net transfers reached a staggering $50 billion. The developing countries continue to hemorrhage even as the banks have happily recovered from the crisis.

III. ADJUSTMENT POLICIES: A CURE-ALL?

In 1985, the dominant thinking was that the global debt crisis could be solved by adjustment programs with growth as the aim. This was the prescription imposed by multilateral lending institutions and supported by commercial bank creditors and creditor countries.

Adjustment policies were implemented by debtor countries as a conditionality for additional loans primarily from the multilateral institutions like the World Bank and the IMF. Likewise, new money from the commercial banks was contingent on the successful implementation of adjustment programs which were closely monitored by the multilaterals. Developing countries, most of them in Sub-Saharan Africa, and a number in Latin America, and Asia, have been subjected to this shock treatment.

What is structural adjustment? According to the World Bank, structural adjustment includes "a range of measures intended to reduce internal and external deficits, increase efficiency in the economy, and reduce government expenditure. Typically, they would include (I) changing the exchange rate to reflect more closely the true value of the currency...(2) reducing government payrolls, (3) selling to private interests or dismantling government-owned enterprises; (4) raising agricultural prices closer to world market levels... and (5) reducing subsidies both on consumption items, including food, and to producers."

While the objective is to "adjust" the economy, the real targets of adjustment are the people. They get thrown out of jobs; their incomes are reduced because of rising prices; and they pay more for basic commodities and necessities. Adjustment involves changes in economic policies; actually it is people who are adjusted out of jobs, homes, schools, and in extreme cases, out of existence.

Between mid-1980 and February I988, The World Bank and IDA undertook more than I30 adjustment operations in 55 countries. These were complemented by adjustment programs undertaken under IMF supervision. Debtor countries who borrowed from both the World Bank had the double misfortune of being subjected to several adjustment programs. More than 70 countries have undergone adjustment programs under the tutelage of the World Bank and the IMF during the eighties.

What has been the result of these massive adjustment operations? The World Bank itself has admitted that "an end to the debt crisis remains elusive.... Debt disbursed and outstanding has doubled, and debt service payments on a cash basis are one-third higher....Despite adjustment measures, growth rates in the HICs (highly indebted countries) and in low-income Africa are still low and investment levels well below those reached during the I970s.

So much has been sacrificed, and millions of people have been subjected to hardships for such unsatisfactory results.

Thus far, the evidence on adjustment has shown that it is the people of the debtor countries who are paying for the adjustment programs with their very lives, but it has only been the banks and the industrialized countries, and the international financial system which have recovered.

IV. ADJUSTING OUT DEVELOPMENT

What has been the impact of adjustment on indebted countries? While adjustment has become the rallying cry for the eighties, it has actually been a standard cure-all of the IMF since the sixties. However, criticisms against

adjustment operations has increased dramatically because of the experience of the eighties.

The harrowing experience of adjustment during the eighties has brought about universal recognitions of the untold suffering wreaked on hapless peoples. Criticisms have been raised by concerned international institutions, primarily the United Nations, non-governmental organizations, religious organizations, and academics. The World Bank and the IMF themselves recognize the direct link between their adjustment programs and rising levels of poverty.

Perhaps the most comprehensive evaluation of the impact of adjustment on developing economies is the well-known study of the UNICEF, *Adjustment With a Human Face*. It is a moving plea for protecting the vulnerable who have been hardest hit by adjustment programs simultaneously conducted during the eighties. The case study on the Philippines is particularly graphic. The impact of the series of adjustment programs in the Philippines was evaluated in terms of effects on household incomes and consumption, consequences for rural welfare, impact on government expenditure, and social impact, e.g. on health, nutrition, education, housing, women and children. Severe deterioration in these areas was noted.

Another UNICEF publication, *The State of the World's Children: 1989* discusses in horrifying numbers the effect of adjustment processes on the poor, particularly the children. Requirements for reduction in expenditure have resulted in sharply reduced budgets for health and education in most of the countries of sub-Saharan Africa, in more than half of the countries of Latin America and the Caribbean, and in one third of the nations of Asia. Reduced expenditures have not been marginal. In the 37 poorest nations of the world, spending per head on education was reduced by nearly 50% and on health care by nearly 25% in the last 10 years. A UNESCO report confirms deterioration in quality of education, stagnating enrollments, massive dropt-outs, inadequate teacher's pay and other indicators.

More than any other group, the children of the developing countries were the innocent bearers of the terrible burden of adjustment. The UNICEF has reported that during the decade of the eighties, more than one million children died from malnutrition and deteriorating sanitary conditions. This was to a large extent due to the sharp reduction of expenditures for health, in compliance with adjustment conditionalities for reduced government spending.

During the decade of the 80's, more than 50% of government expenditures in developing countries went to national defense and debt servicing.

Even the IMF, the most ardent defender of adjustment had recognized the impact of such policies on the poor. The Managing Director of the IMF, Michel Camdessus, has been quoted thus, "Too often in recent years, it is the poorest segments of the population that have carried the heaviest burden of economic adjustment." Again, referring to the Philippines, a study on the impact of stabilization policies and income distribution in the Philippines by two economists from the World Bank and IMF, respectively revealed the following conclusion:

> *"Clearly, the macroeconomic adjustment in the Philippines in the 1980s adversely affected the poor, mainly through the increase in underemployment that followed the stabilization program. The increase in underemployment had a high social cost because it had a more serious effect on those workers who had the least specific skills....The low income brackets were also hit by the increase in inflation. The poorest segments bear most of the burden of inflation."*

An OXFAM study, *Debt and Poverty: A Case Study of Zambia*, details the impact of debt and adjustment not only in terms of numbers but more on people. Particularly moving is the account of the effects of the removal of food subsidy on the poor of Zambia. Impact was expressed not in number but of people with names, faces and shattered aspirations.

There is no lack of researches, reports, studies and evaluation of the effects of adjustment on the poor people of the developing countries. There is no lack of compassion either. Or even anger. What is lacking is effective action.

The UN Declaration on the Right to Development defines development as "comprehensive economic, social, cultural and political process, which aims at the constant improvement of the well-being of the entire population and of all individuals on the basis of their active free and meaningful participation in development and in the fair distribution of benefits resulting therefrom."

If development means the improvement of the quality of life of the people of developing countries, then the effects of adjustment are clearly anti-developmental. What has resulted is deterioration, not improvement.

V. ADJUSTING OUT HUMAN RIGHTS

At present, the impact of adjustment on the peoples of developing countries is well-documented. At the same time, escalating levels of human rights violations in developing countries have been assiduously recorded.

Nonetheless, the fact that external debt and adjustment policies are contributory to human rights violations has not been sufficiently emphasized.

External debt and adjustment policies violate the right to development as a human right on at least six counts.

Firstly, when developing country governments went into an orgy of borrowing supposedly for development, this was done without consulting their citizens. Generally, it is the executive branch of government which enters into negotiations with lending institutions. More often than not, the Ministers of Finance and Planning, and the Governors of the Central Banks are the only ones who know the details of loan agreements and negotiations. Decisions about expanding levels of borrowing and under what conditions are usually considered too technical and sophisticated to be shared with the man on the street. Thus, decisions to borrow are only made public after the negotiations have been completed.

While many developing countries had pretensions to being democratic, information about external debt were generally unavailable. Financial and economic matters are considered too important to be shared with the people. Nevertheless, it is they who pay for the consequences of such "technical decisions."

When decisions are made to add to the financial burdens of citizens without consultation, human rights are clearly violated.

Secondly, when economic crisis ensue as a consequence of the external debt, the immediate victims are the citizens. They suffer for decisions which they never made. When the global debt crisis erupted, many developing countries, particularly those in Sub-Saharan Africa and the Philippines had negative GNP growth. Statistics can not sufficiently describe the horrors of famine, ill-health, unemployment and other forms of suffering undergone by the poor of these countries, especially the children.

When people are made to suffer for crises they are *not* responsible for, human rights are flagrantly violated.

Thirdly, the standard cure which has been adopted -- adjustment -- has made the patient more sick than ever. This was pointed out in the preceding sections. In spite of all the noble intentions, adjustment policies, more often than not, had a negative impact on development as defined by the United Nations.

When people are suffering from a disease they are not responsible for, it is bad enough. When they are made to suffer even more from the terrible

consequences of a cure, that is adding insult to injury and violates human rights.

Fourthly, in the continuing search for lasting solutions to the debt crisis, many developing countries do not consult affected and concerned groups. First of all, they consult their creditor banks and the multilateral institutions. They also consult the creditor countries. But they hardly consult the victims of external debt and adjustment. Worse, the people are not mobilized in the continuing search for solutions which will protect the vulnerable.

When people are ignored and are not considered in the effort to solve the external debt crisis, it is an insult to them and violates human rights.

Fifthly, adjustment programs and strategies to solve the debt crisis are implemented without the consent of those directly affected. The Philippines is a case in point. In 1989, the government, through the Central Bank and the Department of Finance, entered into two major agreements on the external debt which had wide-ranging implications on the people. The first agreement involved the submission of a Letter of Intent to the International Monetary Fund requesting for an EFF (Extended Fund Facility) loan of approximately $1.3 billion under very stringent conditionalities, payable in four years time. When the details of the negotiations were made public after agreement had been reached, there were waves of protest and resistance. Nevertheless, the government went ahead with the program. The consequences of implementing the conditionalities of the IMF program led to an exacerbation of the poverty problem. This was because expenditures had to be reduced, even as taxes were increased and power, transportation, and water rates were raised.

The second agreement was with the commercial banks. Again, details were announced only after negotiations were finalized. Ironically, it was only after these two agreements were completed and implemented that the Philippine Foreign Debt Council conducted public hearings on the external debt.

Implementation of adjustment programs without the knowledge, participation and consent of the affected, especially if such programs will entail much hardship and sacrifice is another form of human rights violation.

Finally, implementation of adjustment policies have sparked widespread resistance from the people. Strikes, demonstrations, food riots and uprisings have been reported in countries implementing adjustment programs. In some dramatic instances, popular uprisings against heads of states can be traced to resistance against repressive adjustment policies which assure payment of external debt at the cost of people's sufferings.

Even in countries which are supposedly democratic, cases of human rights violations have escalated with the implementation of adjustment programs. The infliction of physical violence and the brutal repression of opposition to government policies on adjustment are outright violations of human rights.

What are the human rights issues in external debt and adjustment policies? One issue is the right of a country and its people to development. This is embodied in the UN Declaration on the Right to Development. A related issue is the issue of national sovereignty and the right of nations to work out their own paths to development, taking into account national interest. In the case of indebted countries, national sovereignty is compromised since it is the lending institutions which determine economic policies and shape development models as conditionalities for lending. In extreme circumstances, it is these lending institutions who practically manage the economic and financial affairs of these countries.

At the level of individuals, organizations and communities, another human rights issue is the right to be consulted, to be informed, to participate and to give consent to programs which directly affect them.

Another human rights issue at the level of individuals, communities, and organizations is the right to criticize and resist policies which violate the right to a better quality of life and only bring deterioration, disease and even death.

Finally, there is the right to resist brutality and oppression when these are inflicted to forcibly implement adjustment policies.

VI. SOME SUGGESTIONS

As pointed out earlier, there is no lack of documentation on the negative impact of adjustment programs on development and human rights. There is no lack of data either on the escalation of human rights violations during the eighties -- a development which coincides with the exacerbation of the global debt crisis. Still, the external debt crisis continues and human rights are violated.

What can be done?

Much work is being done by international institutions, especially those in the United Nations to inform the world about the tragedy of external debt and adjustment. However, the direct relationship with human rights violations needs to be given greater emphasis.

1. At the level of the organizations in the United Nations, effectiveness of different but related campaigns might be enhanced if these are coordi-

nated and integrated with human rights campaigns. For example, UNICEF, UNESCO and UNCTAD have come out with studies on the global debt crisis, its impact on the vulnerable, and steps which must be undertaken to arrive at a lasting solution. Their information campaigns can be integrated with the human rights campaigns of the UNCHR.

2. At the level of international organizations and NGOs, a number of campaigns are now being conducted on the global debt crisis. There is the European Bank campaign spearheaded by leading Catholic, Protestant and non-religious organizations in Europe. There is the Berne Declaration Group which is based in Switzerland. In the United States, there is the Debt Crisis Network, INTERFAITH, and other campaigns led by different religious organizations.

At the same time, there are also many human rights campaigns being carried out on an international scale. Again, these separate campaigns can be integrated and coordinated. This is necessary, because as pointed out repeatedly in this paper, external debt and adjustment have contributed directly to the escalation of human rights violations.

3. Similar networking can also be conducted at the country level by cause-oriented organizations working separately on human rights issues and external debt problems.

4. For the past three years, many organizations, notably those in the United Nations have been pressing for "Adjustment with a Human Face". UNCTAD has proposed a 30% across-the-board- cut on commercial bank debts of developing countries. Meetings have been called -- all calling for protection of the victims of adjustment. These calls have been largely ignored by creditor banks and even debtor governments. Action is needed to press for a positive response.

Work on the problem of external debt is being undertaken at two separate levels. At one level, we have the UN organizations the international organizations, the NGOs, the cause-oriented organizations who are all calling attention to the social costs of adjustment. At another level we have the creditor banks, the creditor countries and the debtor governments who are also doing their own thing. In many instances, and in many countries, the latter ignore the former. It is necessary to work out mechanisms to facilitate dialogue between and among those who look at different aspects of the external debt in order to assure action and response.

The impact of external debt and adjustment policies on development and human rights can not be denied. In the process of adjustment, development has been adjusted away; human rights have been adjusted away; if corrective action is not undertaken, people might be adjusted away.

PART V

STATE ACCOUNTING

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CHAPTER 17

STATE ACCOUNTING IN THE PHILIPPINES

INTRODUCTION

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STATE ACCOUNTING IN THE PHILIPPINES

INTRODUCTION

State accounting is that branch of accounting which encompasses the process of analyzing, recording, classifying, summarizing, and communicating all transactions involving government funds and property, and interpreting the results thereof[1]. It performs several important functions. It records, measures, and analyzes the financial and operational performance of government agencies and instrumentalities. It also attests to the integrity of transactions through verification and evaluation. Further, it communicates to agency management information vital for decision-making, control, and supervision.

As a service activity, it has the primary function of providing quantitative information, mainly financial in nature, for informed management action[2]. As a component of public fiscal administration, state accounting serves as an information and processual base for macroeconomic fiscal planning, government budgeting, debt management, and state auditing. Fiscal planners use accounting information collated from all government agencies and instrumentalities in estimating national revenue and expenditure targets. Budget authorities rely on accounting to monitor and control expenditures. Finance and monetary officials monitor disbursement of loans and grants through accounting systems. Government auditors review accounting books and records as a basis for their analysis and recommendations.

State accounting also serves as a tool for management control and supervision. Agency administrators depend on accounting processes to enforce the system of internal checks and control on agency operations particularly on the use of agency resources. Accounting also provides accurate, timely and relevant information for evaluation of agency operations and programs. Thus, accounting is central to the enforcement of public accountability; it serves as a process by which public officials are made to account for their stewardship of public office.

State accounting thus strongly influences not only the entire fiscal administration system but also the performance of government in pursuing its national development agenda. In turn, such strategic a role has posed huge challenges to state accounting. This Chapter discusses state accounting practice in the Philippines and highlights some issues and problems affecting state accounting theory and practice.

I. NATURE OF STATE ACCOUNTING

State accounting as a process involves a series of activities pertaining to the gathering of data used as a basis for policy and management decision-making. These activities include:

1. Bookkeeping which involves recording and analysis;
2. Posting, grouping or classifying of similar items (e.g., arranging items according to account classifications, liquidity, or nature);
3. Preparation of periodic financial reports such as the trial balances, financial statements, and supporting schedules; and
4. Analysis of the financial reports to determine their accuracy and adequacy as well as the efficiency and effectiveness of agency operations.

As a system, state accounting consists of ledgers and books of original entry, the supporting records, documents and reports, and the procedures necessary to provide an effective accounting for the resources and operations of an accounting entity.

II. OBJECTIVES OF STATE ACCOUNTING

State accounting is a service-oriented activity with the basic objective of providing quantitative information about a government entity for:

1. Assessing the stewardship and other aspects of the performance of public officials for which they are accountable;
2. Planning, program selection and budgeting; and
3. Making decisions involving the effective and efficient allocation and control of government resources[3].

These objectives relate to (a) the need to satisfy the accountability requirements of those responsible for the conduct of government activities and operations, and (b) the control of government resources[4].

State accounting is thus expected to generate and report information on the financial position and results of operations of government as a basis for policy and administrative decisions. It is also to provide control over the receipt, disposition, and utilization of public funds and property.

III. BASIC FEATURES OF STATE ACCOUNTING

1. Basis

State accounting is strictly anchored on specific laws, standards, rules and regulations. The government accountant may follow generally-accepted accounting principles (GAAP) only in the absence of specific law or rules and regulations. In case of conflict between generally-accepted accounting principles and legal provisions, the latter prevail. State accounting rules and regulations are promulgated exclusively by the Commission on Audit (COA) as mandated by the Constitution. The most significant of these is the "State Accounting Standards" issued and prescribed through COA Circular no.86-263 dated 16 October 1986. Based on such COA issuances, accounting systems are developed by the different government agencies with the approval of the Department of Budget and Management (DBM).

The whole system of accounting principles and standards developed and prescribed by authorities compose the body of generally-accepted accounting principles (GAAP) or standards.

The GAAP consists of the body of conventional and recognized methods of handling accounting data and preparing financial statements and are intended to achieve the basic accounting objective of providing useful accounting information.

Accounting principles or standards serve to:

a) guide accountants in identifying, measuring, and communicating accounting information;

b) assure proper reporting and a reasonable degree of uniformity and comparability among the financial statements of different government entities; and

c) provide auditors with a basis and framework for making judgments about the fairness of financial statements.

Accounting principles and state accounting rules and regulations are influenced by economic, political and administrative changes and demands in the society and government. They must be in constant adjustment to the information needs of agency administrators, oversight bodies, and national policymakers. The COA develops state accounting standards from a careful study of the information needs of the governmental environment, the current practice in both local and international setting, and the views of academicians, international accounting bodies, and professional organizations.

The development of state accounting principles, rules, and standards should:

a) lead to the accomplishment of the basic purposes and objectives of state accounting;

b) be based on sound conceptual foundation;

c) be feasible and practicable for implementation;

d) conform to legal and administrative requirements;

e) receive substantial acceptance and support from practitioners, users and auditors; and

f) harmonize to the extent practicable, with standards in the private sector and with international principles.

State accounting is founded primarily on the principle that all public funds and property must be duly accounted for. Public officials in possession of such funds and property are accountable persons and must render account of their use and disposal. The law provides: "Except as may otherwise be specifically provided by law or competent authority, all moneys and property officially received by a public officer in any capacity or upon any occasion must be accounted for as government funds and government property..."[5].

2. Organizational Responsibilities

The maintenance and development of state accounting rules, systems and principles is the responsibility of several government offices.

The COA promulgates accounting rules and regulations, prescribes the standard government chart of accounts, and exercises technical supervision over the accounting functions of each agency. It also acts as a National Accountant, through its Accountancy Office by keeping the general accounts of the National Government.

The DBM is responsible for the design and approval of the accounting systems of government agencies. It also determines accounting and other information necessary to monitor budget performance and assess effectiveness of agency operations. It prescribes the forms and schedule for submission of budget reports.

The different national government agencies, local government units and government owned-and/or controlled corporations are responsible for main-

taining their own in-house accounting systems pursuant to laws and rules and regulations issued by the COA and the DBM.

Other agencies like the Bureau of the Treasury (BTR), the Bangko Sentral ng Pilipinas (BSP) and the Securities and Exchange Commission (SEC), as well as international bodies such as the US General Accounting Office (GAO) and the International Accounting Standards Committee (IASC) also issue accounting standards that guide the development of state accounting.

3. Accounting Entity

An accounting entity is the object of accounting measurement and reporting. Accounting involves the accumulation of information about a certain entity and the communication of such information to end-users[6]. In state accounting, the accounting entity is the fund; this is because state accounting is done by fund. Each fund is treated as an independent and distinct fiscal entity with self-balancing set of accounts. In financial accounting, the entity is usually the business enterprise.

4. Double-Entry System

State accounting uses double-entry bookkeeping. Under this system, three basic elements define the financial position of an agency, namely:

a) resources of agency
b) claims of creditors
c) equity of the government as owner/proprietor

where:

a) resources refers to the actual assets of any agency of the government such as cash, instruments representing or convertible to money, receivables, lands, buildings, equipments, as well as contingent assets;

b) claims of creditors refers to liabilities; and,

c) government equity is assets less liabilities.

To maintain equality in the double-entry system, the amounts debited should always equal the amounts credited.

Assets are things of value that may or may not have physical forms. These are the economic resources of the agency used in agency operations. In state accounting, fixed assets are charged to current expenditures and

are capitalized through the use of a corollary entry, the sale of which is considered as income (not return on capital). On the other hand, contingent asset is used to record any shortage in the accounts of a disbursing officer pending final settlement or disposition.

Liabilities are obligations or debt of the agency to an outside party. These include: obligations incurred for services rendered or goods delivered which have not yet been actually paid; trust accounts or moneys received from another agency/party; and payments or contributions withheld from employee compensation for remittance to BIR, GSIS, Pag-Ibig, and the like.

Surplus and capital include the equity of the owner (government) on the agency. Equity is the owner/proprietor's financial interest. Surplus account (instead of ownership account as in private financial accounting) is used in state accounting. Surplus is the excess of the assets and other resources over the liabilities, obligations, and liability reserves.

5. Negative Entries

State accounting uses negative entries. When errors are committed, erroneous entries are recorded again but in the negative so that when totals are derived, the amounts erroneously entered are automatically removed.

6. Time Period

Accounting provides information about the economic activities of an accounting entity for a specific time period. In state accounting, the basic time period is one year. The calendar year is the fiscal year.

7. Basis of Accounting - Cash and Accrual

State accounting uses the cash basis in accounting for revenue. The cash basis means the recognition of revenue only at the time cash is received and when cash is disbursed. Accounting for expenditures is strictly on accrual basis pursuant to legislative and budgetary accounting requirements. This means the recognition of revenues when they are earned and expenses when they are incurred regardless of whether cash is received or not. On the other hand, financial accounting adopts a strict accrual basis for both income and expenditures.

8. Recording Procedures

Transactions are usually recorded in the books of original entry or journals. For transactions which are very common and routine, special journals are used to facilitate and simplify recording. The special journals used in each system of state accounting are as follows:

a. **National Government**

(1) Journal and Analysis of Obligation (JAO)
(2) Journal of Disbursement (JD)
(3) Journal of Checks Issued (JCI)
(4) Journal of Bills Rendered (JBR)
(5) Journal of Collections and Deposits (JCD)

b. **Local Government**

(1) Journal and Analysis of Obligations
(2) Journal of Collections and Deposits
(3) Journal of Disbursements by Treasurer/Disbursing Officer
(4) Journal of Checks Issued
(5) Journal of Bills Rendered

c. **Government Corporations**

(1) Sales Register
(2) Cash Receipts Book/Register
(3) Cash Disbursement Book/Register
(4) Check Register

All three sectors however use the journal voucher for recording in the General Journal, transactions which are non-recurring, as well as the opening, adjusting, and closing entries.

After all transactions are recorded in the general and special journals, entries therein are posted in the book of final entry or the general ledger. When details are needed to be indicated for a particular general ledger control account, these are posted in subsidiary ledgers.

9. **Books of Accounts**

Accounts are the records kept for each type of asset, liability or the residual equity/surplus and capital. Changes as a result of transactions are entered in the related account. Transactions are the events that occur in the course of the operation of the agency and change in the composition of assets, liabilities, and the residual equity/surplus and capital. To distinguish one account from another, each account has a name or account title.

There are two major types of books of accounts:

a. *Books of original entry* - journals or records for classifying and recording transactions in chronological order; and

b. *Books of final entry* - ledgers or records for classifying and summarizing the effects of transactions on individual accounts.

There are three sets of books of accounts in state accounting, namely: 1) the National Cash Accounts books maintained by the Bureau of the Treasury for the control of the over-all cash position of the national government, 2) the Cumulative Results of Operations Unappropriated (CROU) books (current surplus account books) of the COA to monitor national government residual equity (surplus), and 3) the agency books maintained by the agencies to record their financial operations.

In books of accounts, state accounting includes budgetary accounts; financial accounting rarely takes up budgetary accounts. In fact, the use of budgetary accounts is unique to state accounting and highlights the emphasis of accounting on compliance with budgetary regulations and requirements. The budgetary accounts in state accounting are: the Residual Equity accounts (Current Surplus) which is the difference between current assets and current liabilities. It represents expendable resources and is available for appropriation. Budgetary accounts are utilized to control expenditures and monitor compliance with budgetary requirements. Invested Capital (Invested Surplus) is the difference between fixed assets and long-term liabilities and is not available for appropriation.

10. Documentation

State accounting rules and regulations require that all transactions are to be supported by sufficient, formal written documents, with complete and accurate description of the transactions, its peso amount, authorization and other substantiating information. The source documents provide the basic data for transaction analysis and the resulting entries, and constitute a record so that the event and the measurement of its effects on the entity can be subsequently verified.

11. Use of Standard Chart of Accounts

The three systems of state accounting - national government, local government and commercial - are unified through the use of a common Standard Government Chart of Accounts (SGCA) to effect uniformity in accounting and reporting, facility in consolidation of financial reports, and adaptability to computerization.

The SGCA is a list of ledger accounts used by national and local government agencies and units as well as government-owned and controlled corporations. It consists of balance sheet accounts and budget/operation accounts. These are general ledger accounts for assets, liabilities and residual equity (or surplus) accounts, including control accounts for revenues

and expenditures. The control accounts have subsidiary ledger accounts showing the details thereof, as well as the details of income and expenditures.

The SGCA provides adequate accounts to cover all types of transactions expected and sufficient information for reporting purposes. Each account indicates its purpose and describes accurately and concisely its contents, including instructions when to debit and when to credit. It provides sufficient breakdown of assets, liabilities, income, expense, and residual equity (surplus) to establish accountabilities, control operations, and develop cost accounting system, whenever necessary.

Through the SGCA, the agency can review its activities according to selected areas of responsibility, such as for each division or field office. It also provides a clear definition of obligation accounting as a tool for better budgetary control. It furnishes information regarding sources of income and the investment in capital items which are important items in fiscal and economic planning. Lastly, it facilitates the preparation of trial balances and their orderly consolidation at the national level.

12. **Coding Structure**

Due to the need to pinpoint responsibilities, functions, or services, the need for itemization of expenditure and income; as well as the volume of transactions in government, the formulation of a coding structure became a necessity. The coding structure systematizes recording, facilitates analysis, and expedites, consolidates, and enhances reporting. The pattern of general ledger account is as follows:

a. Statement Sequence Code - one digit for nominal/budgetary accounts (0 to 7) and for balance sheet accounts (8)

b. Major Code - two digits for broad account classification, such as:

   01 to 50 expense accounts.
   51 to 69 income accounts.
   70 to 80 asset accounts.
   81 to 89 liability accounts
   90 to 99 residual equity (surplus) and capital accounts.

c. Minor Code - three digits for the sub-classification of more specific items within a major code (account)

Expenditures are also coded, based on the function for which these are incurred. The functional classification of expenditures are enumerated in Section VI-E of this chapter.

13. Financial Statements

Financial statements are the end-products of the financial accounting process. The financial statements reflect the financial position of an agency at a moment in time and the results of its operations and one or more kinds of changes in its financial position during a certain period of time. They are the principal means by which the comprehensive information accumulated and processed in the accounting system is periodically communicated to end-users.

Some of the elements of a financial statement are:

a. balance sheet - which shows the assets, liabilities and residual equity (surplus) of a government agency;

b. statement of operations - which shows the elements entering into the computation of the net income (loss);

c. statement of changes in residual equity (surplus) - which shows the balance of residual equity at the beginning of the year, allotments received, expenditures incurred, income for the year, and the various items that increase or decrease residual equity that are neither income nor expenses, to arrive at the balance of residual equity at the end of the year.

The preparation and submission of financial statements and other accounting reports to the authorities concerned are to be guided by the basic and operational objectives of state accounting as prescribed in the "State Accounting Standards".[7]

14. Financial Reports

Financial reports prepared by agencies are based on trial balances and financial statements. The trial balance is a complete listing of totals and balances of control accounts. It may be preliminary or final. The financial statements are composed of (a) the balance sheet which represents the financial conditions of an accounting entity as of a given date, and (b) the statement of operations which presents the results of operations of an agency at the end of a certain period. (Annexes I to IV)

Government agencies submit their financial reports to the President, the Department of Finance, Department of Budget and Management, the COA, and other oversight bodies.

15. Internal Control

State accounting also provides a system to ensure that funds are utilized only for legal purposes and are expended in compliance with rules and regulations. The system is called the internal control system which is the plan of organization and all the coordinate methods and measures adopted within an organization to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage compliance with prescribed policies and regulations. Some elements of an effective internal control system are:

a. **organizational structure** - clear-cut delineation of authority and responsibility

b. **procedures** - definite steps to be followed in the conduct of responsibilities

c. **physical and mechanical facilities** - safes/vaults adequate storage space and facilities, mechanical devices, business machines, cash registers, etc. for protection against losses by/thru theft, malversation, fraud or action of the elements.

d. **accounting and other records** - information on the day-to-day fiscal and operational activities

e. **reports**

f. **standards of performance** - yardstick against which accomplishment and results are measured

g. **internal auditing** - independent appraisal conducted within an organization to assist management decision-making

In state accounting, an effective internal control system must adhere to the following principles:

a. Responsibility must be fixed.

b. Accounting control and operations must be separated.

c. No one person should be in complete control of a transaction.

d. Employees must be carefully selected and trained.

e. Instruction should be in writing.

f. Accountable officers must be bonded.

g. Controlling accounts should be used extensively.

h. All cash receipts should be deposited intact.

IV. GOVERNMENT ACCOUNTING SYSTEMS

There are three systems of state accounting:

1. **National Government Accounting** - that which is used by the different departments, bureaus, offices, and the field offices and operating units of these agencies. Under this system, the Congress appropriates funds for government, the BTR acts as the bank, the departments and offices spend their appropriations while keeping accounting records, and the COA keeps the general accounts. At the end of the year, the departments and their offices submit to the Accountancy Office of the COA their trial balances and financial statements which the latter consolidates to come up with the annual financial report of the national government.

National government accounting uses three sets of books of accounts: (a) the books maintained by the BTR for the control of the over-all cash positions of the national government; (b) the books of agencies to record their financial operations; and (c) the books of COA for the control of the cumulative residual equity (current surplus) of the national government.

2. **Local Government Accounting** - used by provinces, cities and municipalities. The local government unit records the cash account, operating costs, as well as the surplus in one set of books of accounts. At year end, the local government units submit their trial balances and financial statements to the Local Government Audit Office which prepares the annual financial report for local governments. Each LGU installs and maintains its own books of accounts.

3. **Commercial Accounting** - used by the private sector but applied by government-owned and/or controlled corporations with proprietary functions. All GOCCs submit their financial statements to the Corporate Audit Office of the COA for preparation of its annual financial report for government corporations. Each corporation sets up and maintains its own books of accounts.

V. FUND ACCOUNTING

The accounting system of a government office is established and operated on the basis of a fund instead of a single unified set of accounts for the organizational unit as a whole. Fund accounting evolved because of the diverse nature of government operations and the need for fiscal controls to ensure compliance with rules and regulations.

A "fund" is defined as "a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources; together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.

National Government Funds are generally classified as:

1. **General Fund** - includes cash and other resources of the government which are generally available for all functions of the government and from which are segregated any amounts not specifically designated to another fund;

2. **Special Fund** - fund created for a special purpose or object and used to defray specified expenditures or classes of expenditures;

3. **Bond Fund** - fund arising from bonds floated by the government for specific purposes such as permanent public improvements;

4. **Fiduciary Fund** - a fund in which the assets are administered by the government in trust or fiduciary capacity; often called a "trust fund";

5. **Depository Fund** - a fund over which the officer accountable therefor may retain control for the lawful purpose for which the same came into his possession being subject to his check for such purposes;

6. **Redemption Fund** - fund established for the purpose of extinguishing indebtedness or reacquiring capital stock; and

7. **Sinking Fund** - fund for the periodic segregation of sums of money sufficient to retire bonds or other debts at specific or stated intervals.

Under PD 711 the national government adopted a "one-fund concept" whereby all revenues and receipts accrue to a single General Fund, and are available for utilization. A number of decrees were issued establishing a limited number of special funds which were intended for certain major

projects requiring substantial funding. Under PD 1234, all such special funds were converted into special accounts in the General Fund.

Under the Local Government Code (RA 7160), the **Classification of Funds in the Local Governments** is as follows:

1. **General Fund** - which consists of monies and resources which are available for the payment of expenditures, obligations or purposes not specifically declared by law as accruing and chargeable to, or payable from, any other fund.

Special accounts are to be maintained in the General Fund for the following:

a. public utilities and other economic enterprises;

b. loans, interests, bond issues, and other contributions of specific purposes; and

c. development projects funded from the share of the local government units in the internal revenue allotment (IRA).

2. **Special Education Fund** - which consists of the respective shares of provinces, cities, municipalities and barangays in the proceeds of the additional tax on real property to be appropriated for the operation and maintenance of public schools, construction and repair of school buildings, facilities and equipment, educational research, purchase of books and periodicals, and sports development as determined and approved by the local school board.

3. **Trust Fund** - which consists of private and public monies which have officially come into the possession of the local government or a local government official as trustee, agent or administrator, or which have been received as a guaranty for the fulfillment of some obligation.

VI. ACCOUNTING FOR APPROPRIATIONS, ALLOTMENTS AND OBLIGATIONS

A. General Principles

Accounting for appropriations, allotments and obligations are governed by the following:

1. No money should be paid out of the Treasury except in pursuance of an appropriation law or other specific statutory authority.

2. Government funds shall be spent only for public purposes.

3. Allotments are to be released to the agencies on a comprehensive basis allocated on a quarterly requirement.

4. The accrual basis of accounting for expenditures should be followed -- expenses whether paid in cash or on account must pass the obligation accounts.

5. All transactions pertaining to appropriation, allotments and obligations should be properly recorded in the pertinent books of accounts.

B. Accounting for Appropriations of NGAs

When the General Appropriations Act approved by Congress is signed by the President, it becomes an appropriations law. Appropriation is defined as an authorization under acts of Congress, Presidential Decrees or other legislative enactments for payments to be made with funds of the government under specified conditions and/or for specific purposes[8].

The appropriation is then recorded and accounted for by the COA as provided in the Constitution. The recording is done by the COA Accountancy Office which has the following functions:

1. To keep the books of the Cumulative Results of Operations Unappropriated (CROU)/unappropriated surplus of the general fund.

2. To record the releases of allotment and appropriations.

3. To prepare the annual consolidated financial report of the national government.

At the end of the year, the Accountancy Office is furnished copies of the trial balances of the different government agencies as bases for keeping the general accounts and preparing the annual financial report.

C. Allotment System in the National Government

At the start of each year, the Department of Budget and Management releases the allotment to the agencies on the basis of a work and financial plan prepared by them based on the appropriations law. The allotment is an authorization to an agency to incur obligations up to a specified amount that is within a legislative appropriation.

The allotment is recorded in the COA CROU Books as well as in the agency books by journal vouchers. In addition, it is recorded in the agency books as a memo entry in the Journal and Analysis of Obligations (JAO), a special journal used to record obligations incurred and monitor and control the unused balance of allotments. A separate sheet is kept for every fund program, project, and activity.

A program refers to the functions and activities necessary for the performance of a major purpose for which a government entity is established; while a project is a component of a program covering a group of homogeneous activities that result in the accomplishment of an identified output.

On the basis of allotments received, the agency enters into contracts or commits itself to purchase goods and services necessary for the implementation of its programs and projects. Each time a contract or purchase order is executed, a Request for Obligation of Allotment (ROA) is prepared to evidence incurrence of obligation. The ROA has three parts, namely: Section A - which is accomplished by the official requesting for the obligation; Section B - which is accomplished by the accountant certifying that funds are available for that particular obligation; and Section C - which is accomplished by the ledger keeper monitoring the liquidation of the obligations. After proper accomplishment of Sections A and B, the ROA is recorded in the JAO.

D. Accounting for Appropriations and Allotments in LGUs

As in the national government, local appropriations are also enacted by the legislative bodies of the local government units, which are the Sangguniang Panlalawigan for provinces, Sangguniang Panglunsod for cities and Sangguniang Bayan for municipalities. But, unlike in the national government, the appropriation is recorded in the books of the LGUs; thus they maintain their own unappropriated surplus.

Requests for allotment are reviewed for conformance with approved local appropriatons before advices of allotments are released on a quaterly basis and issued by the local chief executive not less than five (5) days before the beginning of each quarter. Unobligated balances of allotments at the end of the quarter may be used for subsequent quarters in case insurgencies/financial dislocation unspent balances of allotment may be transferred to reserve as soon as the quarter has been completed. No obligation/expenditure shall be incurred in excess of allotments.

E. Expenditure Classification

Expenditures are classified according to nature, whether the benefits derived from such expenditures extend within a year or more than one year. These are as follows:

1. Current Operating Expenditures
   a. Personal Services (Allotment Code - 100)
   b. Maintenance and other Operating Expenses (Allotment Code - 200)

2. Capital Outlay (Allotment Code - 300)
   a. Land and Land Improvement Outlay
   b. Buildings and Structure Outlay
   c. Furniture and Equipment Outlay
   d. Investment Outlay
   e. Loans Outlay

3. Non-Expenditure Disbursements

On the other hand, expenditures are also classified according to the function of the agency incurring said expenditure. These are as follows:

Sectoral/Functional Classification

	National Government (Sector Codes)	Local Government (Sector Codes)
General Public Services	100	1
National Defense	200	2
Education, Culture, Sports and Manpower Development	300	3
Health, Nutrition and Population Control	400	4
Labor and Employment	500	5
Housing and Community Development	600	6
Social, Security Services and Welfare	700	7
Economic Services	800	8

   a. Agriculture
   b. Natural Resources
   c. Industry
   d. Trade
   e. Tourism
   f. Power and Energy
   g. Water

h. Transportation and Communication
i. Other Economic Services

Sectoral/Functional Classification

	National Government (Sector Codes)	Local Government (Sector Codes)
9. Other Purposes		9

a. Public Debt Amortization
b. Public Debt Interest Payment
c. Multi-Sectoral Services
d. Other purposes

VII. ACCOUNTING FOR DISBURSEMENTS

A. General Principles

Accounting for disbursements is governed by the following:

1. All disbursement shall be made only for duly authorized expenditures and on the basis of duly approved and supported disbursement vouchers.

2. All disbursements made from the National Treasury shall only be on the basis of the Notice of Cash Allocation issued by the DBM except when it is otherwise provided by law.

3. Cash, checks, and accountable forms must be kept in safe custody.

4. Cashbooks of disbursing officer should be kept up to date, footed, balanced and ruled at the end of each month.

5. All disbursements, shall be made by check, except for salaries, wages and allowances, and when the amount is less than P10,000.00, or when a higher amount is allowed by law and/or specific authority by COA.

6. All disbursements shall be reported at least once a month.

7. There should always be two signatories for all checks issued, namely: the signing officer, and the countersigning officer.

8. All transactions pertaining to disbursements should be properly recorded in the relevant books of accounts.

B. Certification of Availability of Funds.

In the national government, the certification of the Chief Accountant or head of accounting unit should first be secured before disbursements may be made or expenditures/obligations chargeable against any authorized allotment may be incurred or authorized in any department, office or agency.

In local government units, disbursements may be made only after (a) the local budget officer has certified to the existence of appropriation that has been legally made for the purpose, (b) the local accountant has obligated said appropriation, and (c) the local treasurer has certified to the availability of funds for the purpose.

C. Notice of Cash Allocation and Modified Disbursement System (MDS) in the National Government [9]

This system (MDS) replaced the CDC System and the Centralized Disbursement System. Monthly, the DBM issues to each agency a Notice of Cash Allocation (NCA), which is an authorization to make disbursements. Like the Cash Disbursement Ceiling (CDC), the NCA is a device intended to effectively control cash utilization in order to eliminate unnecessary cash drawdowns from the National Treasury. But, unlike the CDC whereby disbursements are made by treasury warrants or treasury checks, the MDS requires that agencies covered shall maintain accounts with Government Servicing Banks (GSB), using the NCA as basis to control withdrawals therefrom.

MDS requires that each GSB maintain separate accounts/ledger for each agency and by funds. Agencies concerned are responsible for the reconciliation of their respective MDS accounts monthly and directly with GSB, while the BTR is responsible for the overall cash reconciliation of the MDS accounts.

MDS covers (a) all funds appropriated in the General Appropriations Act; (b) Public Works Acts; (c) Supplemental Appropriations for the different departments and their bureaus, offices, agencies/hospitals; (d) all other funds deposited with the National Treasury (BTR) whether or not requiring special budgets including Special Accounts maintained by national government agencies and those maintained by government corporations.

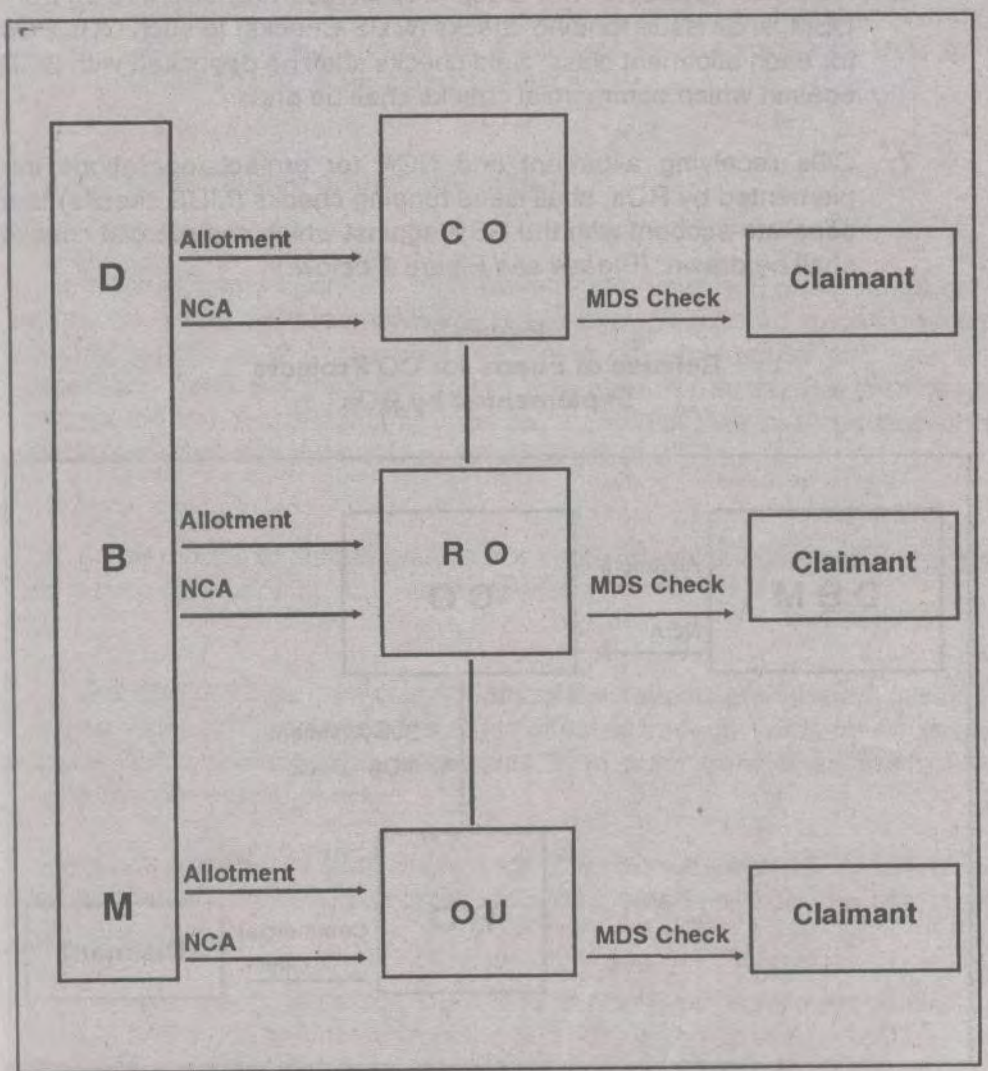
Exempted from the coverage of MDS are (a) Revolving Fund transactions for business-type activities authorized to be deposited with government depository banks; (b) constructive cash requirements/disbursement scheme covering availments for foreign-assisted projects for which Non-Cash Availment Authority (NCAA) is issued by DBM to implementing agencies; (c) utilization of foreign collections of DFA, BIR, DOLE, DTI and DECS; and (d)

agency requirements drawn directly against the Special Account (Working Fund) maintained by BTR with the BSP.

The general policy guidelines for the MDS include the following:

1. DBM shall issue monthly the Notice of Cash Allocation (NCA) directly to NGA Central and Regional Offices (CO/RO) and some specific Provincial Offices (POs)/Operating Units (OUs), as shown in Figure 1 below.

Figure 1
Release of Allotment
and Notice of Cash Allocation (NCA)
Directly from DBM to CO/RO/OU



2. The NCA shall be recorded as a memorandum entry in the Allocation and Utilization Control Sheets (AUCS) to be maintained by both the Accounting and Cash Divisions to ensure that MDS checks issued do not exceed the NCA.

3. A Monthly Statement of Allocation and Utilizations shall be submitted to DBM by the Accounting Division/Unit based on the Report of Checks Issued received from the Cashier.

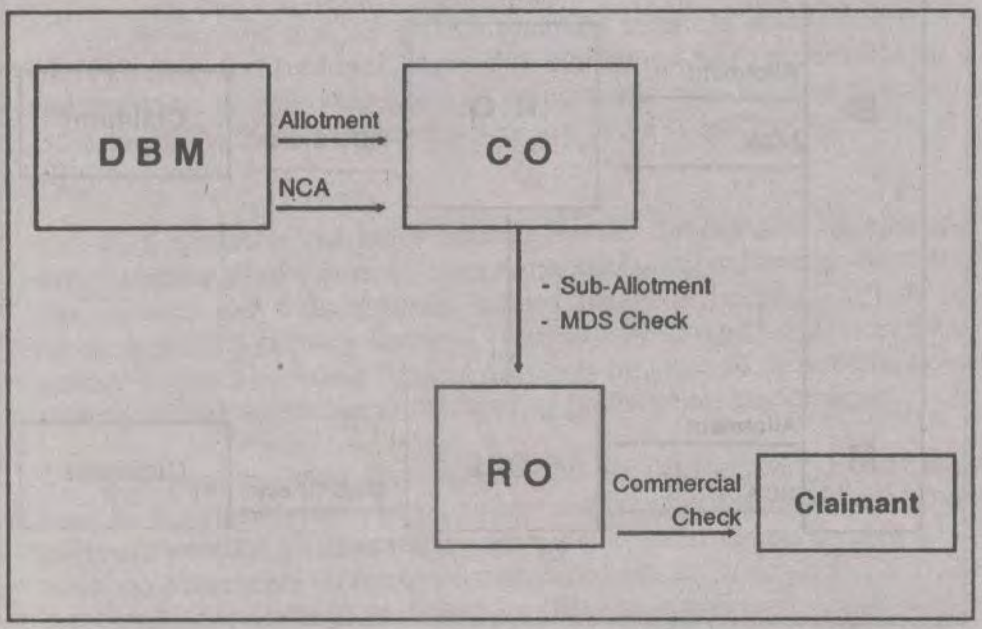
4. Withdrawals or utilization of NCA shall be recorded in the Journal of Checks Issued.

5. Cumulative totals of the allocation and utilization shall be indicated on the last page of the Trial Balance, after the grand totals.

6. ROs that receive NCA for OUs/POs, not receiving NCA directly from DBM, shall issue funding checks (MDS Checks) to such OUs/POs for each allotment class. Said checks shall be deposited with GSB against which commercial checks shall be drawn.

7. COs receiving allotment and NCA for projects/operations implemented by ROs, shall issue funding checks (MDS checks) to a separate account with the GSB against which commercial checks shall be drawn. (Please see Figure 2 below.)

Figure 2
Release of Funds for CO Projects Implemented by ROs



8. All MDS and commercial checks shall be covered by duly approved Disbursement Vouchers.

9. Offices receiving NCA directly from DBM shall remit refunds of cash advances/overpayments to the National Treasury. Those receiving funding checks shall deposit such refunds in the agency current account with GSB.

10. Balance of the NCA at the end of the year shall automatically expire and shall no longer be valid for use in the ensuing year. Prior Year's unpaid obligations shall be paid out of NCA requested/released for the purpose in the ensuing year.

11. Balance of deposits per books of POs/OUs (not receiving NCA directly from DBM), corresponding to unobligated allotment at the end of the year shall be withdrawn for remittance to BTR and covered with a Remittance Advice.

D. Other Modes of Disbursements

In the national agencies, local government units and government corporations, some disbursements are made through cash advances granted to duly appointed or designated disbursing officers (regular and special) depending upon the purpose, nature and need for such. The disbursing officers are bonded depending upon the amount of their cash advances in accordance with the rules and regulations of the BTR.

Other modes of disbursements are those for which commercial checks are issued for operating and other expenses.

Transfer of funds from one Agency of the national government (treated as Inter-Agency Transferred Funds) is effected through Treasury Account-Check Disbursements. Disbursements from such transferred funds are made by commercial checks.

Funds transferred from an agency to its bureau/regional in operating unit is effected similarly. However, disbursements therefrom are made by MDS checks.

Disbursements for which DBM issues Non-Cash Availment Authority (NCAA) and those exempted from the MDS are taken up in the accounts by means of Journal Voucher, recorded in the General Journal.

VIII. ACCOUNTING FOR INCOME AND RECEIPTS

A. General Principles

Accounting for income and receipts are governed by the following:

a. All collections whether from income or non-income sources must be supported by official receipts.

b. Cash collections and accountable forms must be kept in safe custody.

c. Cashbooks of collecting officers/treasurers/cashiers should be kept up-to-date, footed, balanced and ruled at the end of each month.

d. Collections must be deposited intact with the Bureau of the Treasury/authorized government depository bank/provincial Treasury or any other authorized depositories in the frequency set by regulations.

e. Collections must be reported at least once a month.

f. All transactions pertaining to income and collection and remittances/deposits should be properly recorded in the relevant books of accounts.

B. Categories of Income in NGAs

In the national government, income collections are categorized according to their availability for utilization by the agencies. These are as follows:

1. Income totally accruing to the general fund
   Income derived from fees, fines, penalties, surcharges and other sources that totally accrue to the General Fund.

2. Income collected in excess of the approved agency income estimate

   The amount actually collected in excess of the approved estimated income is reflected in the Budget Program and Personal Services Itemization and made available for necessary expenditures of the agency in addition to its annual appropriation.

3. Income made available in whole for agency expenditures

Income derived from services rendered in the exercise of agency functions including assessments in government-owned or controlled corporations and local government units and made available, in its totality, for agency use in addition to its regular appropriations.

4. Income made available in part for agency expenditures

Income derived from services rendered in the exercise of agency transactions and subsequently made available in part for agency expenditure, in addition to its regular appropriations, subject to the limitation (percentage or fraction of total income collected) stipulated in the Special Provisions.

5. Income treated as Special Account in the General Fund

Income collected in pursuance of a Special Act or on account of a special provision in PDs, LOIs, etc., which comprise all income remitted to the National Treasury by government agencies and remittances of government-owned or controlled corporations to the credit of a national government agency and classified or treated as Special Account in the General Fund.

6. Income Constituted as Agency Revolving Account in the General Fund

Income derived from services rendered to private entities and other government agencies including government-owned or controlled corporations to be deposited in the National Treasury/authorized government depository bank to constitute a Separate Revolving Account in the General Fund for additional operating expenses of the agency concerned. The Revolving Account in the General Fund is considered self-perpetuating and all expenses therefrom are borne by fund out of its revenue.

7. Income Automatically Appropriated

Income collected over and above the amount appropriated for the agency which is specifically authorized for outright utilization by the agency for its operation without the need for specific statutory authority provided that the amount of appropriation authorized for the agency has been previously offset or paid-off by an equal amount of income collected and deposited with the National Treasury.

IX. DECENTRALIZED ACCOUNTING

Decentralized accounting is a branch of accounting system used by agencies and government corporations with regional offices or branches. The regional units maintain complete set of books of accounts and prepare the trial balances and financial statements for consolidation at the end of each year in the central or main office.

A. Procedures of National Government Agencies

Upon receipt of the allotment from DBM, COs or ROs prepare SAA which serve as the basis of transferring the authority to ROs or OUs, respectively, to incur obligations for the requisition of goods/services necessary for the implementation of programs and projects. Actual payments for such shall be limited to NCA/ funding checks (MDS Checks)

The rules and regulations applicable in the utilization of allotment and the NCA also apply to those for SAA and funding checks. Disbursements are made by MDS checks/commercial checks and/or cash, which are reported on a semi-monthly or monthly basis as the case may be depending upon the nature and volume of transactions. Copies of these reports are submitted as basis for recording disbursements made by the regional office.

Collecting officers assigned in the regional offices make their collections and remit to the National Treasury through the authorized government depository bank branches. These collections and remittances are reported each month and copies of such reports are submitted as basis for recording.

In accounting for transactions affecting both the central and regional office books, reciprocal accounts are used.

X. ISSUES AND PROBLEMS

A. Keeping Pace with Development Administration Requirements

State accounting is inextricably linked to national development, its goals and priorities, processes an impact. The government accountant is increasingly entrusted with responsibilities that help determine the extent to which our development thrusts will succeed.

Unfortunately, accounting in its name and form, has not grown enough to help spur economic growth and development.[10] The inability of the accounting field to keep pace with development processes and its public administration requirements has been noted since the start of the Development Decades. State accounting, according to program administrators, has

mainly been unresponsive to demands for new and relevant standards, modern methods and criteria of resource measurement, and professional competence. It has been, in fact, according to some, an obstacle to the efficient, flexible and effective execution of past development policies and programs.

This inadequacy has been highlighted even more by the adoption of "sustainable development" strategy which aims to achieve longer-term development gains consistent with optimum resource utilization and level of environmental change. Anchored on the rational and efficient use of "natural capital stock" (natural resources, manpower, financial and institutional assets) for the generation and continuity of desirable social objectives, this strategy requires resource measurement as to costs and benefits which can be provided by state accounting for development planning and policymaking. More importantly, sustainable development gives importance to the environmental changes as a result of economic production and here is where the role of state accounting as a measurement function becomes critical. While some would perhaps claim that the concept of "sustainable development" itself lack rigorous definition and acceptable operationalization as argued by David Pearce and colleagues (1990), others would argue that the present accounting field has been tightly knit into the traditional "economic growth" models of development and its emphasis on physical resources and outputs.

Notwithstanding drastic reforms and reorientation for the last two decades in other fiscal processes such as budgeting and auditing, state accounting to be sure has only veered insignificantly from the role, functions and processes assigned to it by the traditional development models measuring development simply in economic terms (like GNP growth and rise in foreign investments).

State accounting's focus on the measurement and evaluation of public resources (mainly budget and revenues) while salutary to development administration, has been so inordinately stressed that its focus has been on the development and refinement of sophisticated techniques in this direction. Where more progressive methods and techniques are available, these are ignored. One reason for this is the control that goes with state accounting.

There is the negative perception on the role of accounting in development administration that as one of the mechanisms for control and monitoring, accounting is primarily considered as a check-and-control function. The misconception may be traced to the fact that state accounting in the Philippines has for the last decades faithfully fulfilled its assigned role as the controlling mechanisms for public fiscal administration. It is assigned by public administration theoreticians to the oversight and accountability phase of the public fiscal administration cycle. To government administrators, accounting (together with government auditing) unfailingly forms part of the

fiscal accountability segment of development administration in development plans. To the practitioners, accounting is simply one in the array of financial management tools for monitoring, control, and evaluation.

While fiscal control is an inherent characteristic of accounting in order to maximize scarce public resources and enforce accountability, it stymies innovation, flexibility, entrepreneurship, and responsiveness in development administration. Further, this delimits state accounting to the narrow confines of institutional control systems and processes in development administration.

Some attribute this to the failure of education, training and research to provide the directions and structures required for a sustained development of the accounting field.

Specialization in state accounting could be enhanced by proper academic preparation and in-service trainings. This is not possible though without a corresponding infusion of resources on research and development. Research provides the theoretical and practical foundations of any academic instruction or training. It also provides the innovations and adaptations to the complexities and problems of the public financial management system. Research as a multiplier effect which facilitates further development and improvements in training, education and practice which in turn leads to an enhancement of new and better state accounting knowledge.[11]

There is lack of serious research undertakings on state accounting due to the absence of an agency-initiator, lack of funds, and scarcity of well-qualified researchers.[12] These problems are partly responsible for the inability of accounting to adapt to administrative and fiscal reforms. A forward-looking research could have anticipated and prepared for such problems.

The development of literature on state accounting through research grants, professorial chairs, and others, can result to better and more relevant textbooks, case studies, or other instructional and practical materials.

There is some scholarly doubt on whether we have been able to develop a cohesive accounting theory. There are perceived gaps in accounting theory as in the design of its objectives, concepts, standards, and rules. The objectives and concepts of accounting theory have been particularly weak and are mostly derived from generally accepted accounting principles.[13]

State accounting suffers the same deficiencies. One area of state accounting which has to be redesigned is in the standards and rules such that common terminology and classification can be used consistently throughout the budget, the accounts, and financial reports. The DBM and

the COA should continue to develop common areas and reduce the points of differences.

The government, professional associations, and the academe should hold conferences and seminars which can facilitate exposure to development in state accounting and can serve as forums for the exchange of ideas among practitioners, academicians and students.

A Research and Development Center on Government Accounting which can serve as the clearinghouse for state accounting information and publications should be established.

One area where research is most urgent is in the adjustment of the historical cost accounting model to price changes. With such, a current value basis can be evolved for a more precise, accurate, and relevant state accounting for managerial, financial reporting, and auditing purposes.

Another would be in the design of an accounting system where the peculiarities of public ownership and profit orientation of government enterprises can be reconciled in order to develop a state accounting system that enhances better assessment and reporting.

The development of appropriate methods and techniques for measuring and reporting the ecological and social implications of sustainable development policies is one urgent concern. Development policies, especially those of the traditional economic growth models, do not consider the non-economic factors such as social costs on program beneficiaries and thus present only an incomplete picture of the development impact. The lessons of the Development Decades point to the development of indicators that would definitively show a "development with a human face."

There are other urgent concerns: need for timely and accurate accounting information for public accountability; development of more appropriate, relevant and flexible standards supportive of innovative program administration and project management; information on the human impact of development strategies, and so on. To address these challenges, state accounting needs an institutional base. The proposed creation of a central accounting body as its institutional foundation for growth and development has been the subject of recent debate and legislative consideration.

B. State Accounting for Accountability

Accountability denotes the responsibility to others that one or more persons have for their actions and behavior[14].

State accounting enforces public accountability by determining the exercise of responsibilities and use of public office of government officials and reporting these to their administrative and political superiors. Accountability denotes the responsibility to others that one or more persons have for their actions and behavior by virtue of the responsibilities and resources entrusted to them. In government, public accountability means that a subordinate is accountable to his superior and that all public officials and employees are ultimately accountable to the people.

In accounting, public accountability may be operationalized at several levels:

(1) accountability for safeguarding government resources;

(2) accountability for adherence to legal requirements and administrative policies and regulations;

(3) accountability for efficiency and economy in operations; and

(4) accountability for the results and impact of government programs and activities.[15]

State accounting information is thus a focal point in operationalizing public accountability. Public accountability demands that information on the finances, programs, and results of operations of government be furnished those who have the right to such information. These include:

(1) the general public as citizen-stockholders of government;

(2) legislature and other oversight bodies exercising responsibility for policy-making and for supervising and evaluating the performance of government agencies;

(3) government officials who assume primary fiscal responsibility for operations of their agencies and who must ensure that subordinates perform their duties in compliance with policy and regulations.

C. Social Responsibility Awareness and Its Demands

With extensive governmental involvement in development financing and the growing significance of Multinational Corporations (MNCs) in the country's economic life, there is now greater attention to the "social responsibility" aspect of both private and public business activities. What social scientists perceive as the emerging "social responsibility era" is manifested by an accounting for and awareness of the real contributions of these economic activities to the people's socio-economic welfare. From stewardship accounting to decision-making accounting, the accounting field has

branched out with a social accounting function. This new focus requires new forms and procedures of identification, measurement and reporting function of accounting. The reflection of social indicators and corporate socio-economic audits have become new demands on accounting. State accounting is particularly beset by the need to integrate a macro-accounting level of reportage and analysis.[16]

D. Cost Accounting

The development and application of "social accounting" has long been overdue.

Cost accounting deals with current and prospective costs. It supplies information like production cost of a certain good or operations costs which are indispensable to sound financial management. As a managerial type of accounting, it provides the costs information to form a sound basis for planning and review.

In economic planning, we are primarily concerned with the proper allocation of scarce resources to priority sectors or services. Allocative decisions have to be based on a sound evaluation of proposed programs or projects. Such appraisal is not possible without data on unit costs which cost accounting can provide. Cost Accounting is also indispensable in other macro government planning devices e.g. capital-output ratio, shadow pricing, feasibility studies, and others.

The incorporation of cost accounting in public financial management will significantly aid, through cost benefit measurements, the review of agency performance and development programs and projects. Cost data will significantly enhance the quality of efficiency and economy assessments as in state auditing.

E. Timeliness of Accounting Information

The importance of timely accounting information for planning, policymaking and financial management cannot be overemphasized. Policies and decisions based on outdated information leads to costly implications. The lack of accurate and timely accounting information on the foreign debt position of the country during the 70s and 80s when the country went on a borrowing spree has been blamed for the failure of fiscal managers to monitor and effectively manage the country's external liabilities. The "debt bomb" gained the serious attention of policymakers only when it exploded so to speak, in the 80s. By that time, the foreign debt has grown so tremendously that frantic efforts were unable to fully mitigate its negative impact on the economy and the people.

There are real constraints to timeliness in state accounting records: sheer volume of accounting transactions, lack of accounting personnel, distance and inaccessibility of government offices, among others.

Computerization of the accounting process presents an alternative. Aware of the benefits of applying information systems in financial transactions, the government has adopted computerization in the development plans although it lacks resources adequate enough for its full implementation.

F. Neglect of Agency Accounting Functions

Some accounting activities such as preparation of entries for books kept by agencies and bank reconciliation, among others, are neglected or not adequately performed by agency personnel. This resulted to non-accounting personnel (like the auditor before the withdrawal of pre-audit) performing accounting functions of the agency. This made agency rely on an "outsider" for the performance of its regular accounting work. One reason for this is lack of accounting agency personnel and the volume of work.[17]

G. Overlapping Accounting Rules and Regulations

Accounting rules and regulations are not only changed constantly. Some are overlapping and/or conflicting. Codification of state accounting rules should be initiated at the agency and government-wide levels.

Each government agency should prepare its own standard accounting procedures manual adhering to the general principles of the Government Accounting and Auditing Manual (GAAM) [which supplants the National Accounting and Auditing Manual (NAAM) and the Revised Manual of Instructions to Treasurers (RMIT)], with the approval of the COA. This effort may be able to produce an accounting system which can answer the peculiarities of the Agency's goals and functions, administrative and financial structures, and linkages with the fiscal system.

At the national level, the COA should codify general principles of financial information reporting and analysis with a view towards rationalizing the accounting processes, rules, standards, and practices. The result would be a set of accounting principles and procedures that would enhance not only the quality of accounting information, its comprehensiveness and depth, but also an elimination of the duplication of financial reporting.

The agency would then be able to come up with a comprehensive accounting report that would comply with statutory reporting requirements without issuing different reports containing the same data and information.

The Standard Government Chart of Accounts (SGCA) designed by the COA for use of all levels of government is a related effort towards the simplification of state accounting systems and rules.

As the end-user of state accounting, the public sector must take the initiative to develop the field. COA, as the agency charged with the formulation of accounting rules and regulations, and review and evaluation of all accounting activities of the government, should initiate an inventory of all accounting rules and regulations and exert more vigorous efforts toward codification of all rules and standards.

H. *Constraints Due To Budgeting System*

Since state accounting uses obligation and budgetary accounting, there are constraints which are brought about by budgetary procedures. Some constraints are as follows:

(a) Budgetary requirements for reprogramming or realigning procedures complicate accounting work;

(b) Late releases of allotments and notices of cash allocations delay completion of accounting work;

(c) Budgetary procedures for long-term or multi-year projects require voluminous accounting and paper work;

(d) Budgetary system for government loans and grants makes accounting work more intricate.

I. **Volume of Accounting Work**

The increasing complexity and scope of government operations has increased the volume of accounting work to be done, so much so that accounting reports are submitted very late. One particular case is the treasury treatment of deposits made and list of checks issued. The daily average of remittance advices and Treasury Account-Check Disbursements processed by the Bureau of Treasury total to 5,000 pieces and 30,000 pieces, respectively. It takes about three to four months before the BTR can come up with the required statement as basis for reconciliation to be prepared by the accountants.

Some government agencies have started to use computers, but because accounting rules and regulations change from time to time and state accounting requires a high level of specialization, there is still not much reliance on the use of computers.

J. Professional Competence

The fact that most state accounting personnel lack the competence to perform their duties and responsibilities can hardly be ignored. Some of the persistent problems of financial management: late submission of accounting reports, non-reconciliation of agency current accounts and Other Banks-MDS Accounts, misuse of cash advance account, etc.[18] can be traced to the inadequacies in knowledge and skill of the state accountant.

While this problem can be attributed to several factors, many would agree that it is caused by the deficiencies in education, training, and research.

Few agency officials are aware that the lack of competent accounting personnel is due to their own faults. For one, there is no serious effort to recruit competent accountants. For another, some neglect to develop, through training and career development programs, the lower level accounting personnel who perform the bulk of accounting work.

While accounting work demands technical competence, strong sense of responsibility and accountability, government accountants are one of the group sectors in the civil service which are lowly paid. The government should therefore upgrade the pay and incentives of its accountants in order to attract the competent ones or not lose them to other sectors.

K. Problems of State Accounting Education

There is a clear correlation between the deficiencies in the capabilities of the government accountant and the deficiencies of the formal educational system in the field of state accounting. There is ample evidence to show that college graduates majoring in accounting are hardly prepared to assume the duties of a government accountant. This is because the accounting curricula of universities are geared towards the private sector. Government accounting, while a highly technical or specialized field, is a mere 3-unit subject in baccalaureate programs. The student can not therefore acquire extensive knowledge on the field. His ability to anticipate and adapt to numerous reforms in the financial management system is even doubtful. Government accountants are having difficulties adjusting to budgetary innovations and constraints. Technological improvements like computerization of accounting systems can hardly be tackled by an ill-prepared accountant.

In sum, formal education generally does not adequately prepare graduates for accounting career in the civil service. If some universities have attempted to prepare them, the efforts have been inadequate. And yet, ironically, the government absorbs the majority of accounting graduates.

There is thus an urgent need to develop new accounting curricula which would prepare the students for the demands of state accounting and the rigors of a changing financial management system. State accounting instruction could be expanded through curricular development. Additional courses should be created to include the administrative aspects of state accounting, its role in and relevance to public finance problems, and other non-technical issues.

Newer areas of financial management that have a bearing on accounting, e.g., computer technology; feasibility studies; efficiency, economy and effectiveness audits; and others, should be incorporated in the curricula.

The lack of capable and adequate teachers is another problem which affects the quality of instruction. The development of competent, well-motivated, and adequate faculty should be initiated to complement the curricular improvements. Greater pay, scholarship, or other incentives can serve to attract the competent ones into teaching.

All these should then be complemented by the design and development of more relevant and updated teaching aids e.g., textbooks, case studies or charts through well-funded researches, inter-university exchange programs, and consultancies.

Some reorientation of our accounting education is also imperative if we have to develop the corps of lower level accounting personnel. State accounting education could also develop the lower level accounting personnel by instituting a system whereby academic certificates or titles can be conferred upon completion of certain levels of accounting education. Diploma level training carried out by polytechnics or non-formal venues has to be increased greatly. Education should then be concerned not only with upper level training because the lower levels also need great improvement.

Our accounting education is usually geared towards the passing of the board examinations. A board flunker is considered a failure, rather than one who is competent to do less difficult work. Too much bias for "certified" accountants result to a neglect of the lower level or non-CPA personnel e.g., the bookkeepers or cost clerks, in clearer development. Too often, a certified public accountant is favored over the equally competent accounting graduate in recruitment, advancement, and training opportunities. The technical competence as well as morale of the latter suffers because of discrimination.

L. In-House Training

In-house training through non-academic programs is the common alternative to the deficient formal education. As the primary end-user of state accounting, the government has no other option than to undertake by itself

the tasks of giving basic and advanced training on the field. The government has increasingly initiated agency-wide seminars and conferences; post-graduate studies and scholarships, and consultancy programs in order to upgrade its government accountants. These programs, of course, place a tremendous burden on an agency's limited resources. Aside from this, training has its own share of deficiencies.

Many agency heads are hesitant to invest resources in training, even as they recognize its importance. They tend to expect international institutions to take the lead in the field. However, training programs organized by international bodies can only be successful as the extent of cooperation and the inputs coming from the host country. Package programs managed by experts shaped by the experiences of industrialized countries sometimes fail to adequately and effectively meet local training needs. Such seminars sometimes result only in generalized exchange of ideas.

The government has to manifest its commitment to accounting training by investing a substantial portion of its resources. It has to take a more active part in the formulation of training programs suitable and adequate to its local requirements. Professional organizations like the Philippine Institute of Certified Public Accountants (PICPA), the Government Association of Certified Public Accountants (GACPA) and the Association of Government Accountants in the Philippines (AGAP) should extend greater support to and cooperation with the government in such training thrusts.

Training is also constrained by a general attitude that it is not a crucial activity, as compared to actual operation or activities. The tendency therefore is to assign the less effective, the misbehaving, and the erring personnel to training activities or to some other non-priority functions while the "best" ones are fielded in operations. Making the training office a dumping ground for misfits negatively affects the image, the competence, and the integrity of the entire training staff.

The State Accounting and Auditing Center (SAAC) was established by the COA in July 1979 against the background of such constraints and inadequacies. It was created to service the accounting and auditing needs of Supreme Audit Institutions (SAIs) like the Philippine COA. Through research, training, and consultancy, the Center develops new accounting and auditing techniques more attuned to the development objectives and thrusts of developing countries.

Towards the development of the State Accounting field, SAAC, has established linkages with the United Nations, the German Foundation for International Development (DSE), leading academic institutions, and public finance agencies like the Department of Finance (DOF) and DBM in conducting joint training programs on state accounting. Despite the initial

constraints, it has made some modest gains in the short period of three years.[19] SAAC and the former Manpower Development Office (MDO) of COA have been restructured into the State Accounting and Auditing Development Office (SAADO).

M. Creation of a Central Accounting Body

There is a perception that there is poor appreciation of the importance of accounting operations in national financial administration in that while the other fiscal functions and activities, e.g., planning and budgeting are under the supervision and coordination of national agencies like NEDA, DBM and COA, accounting is left to the agency head whose main preoccupation is the implementation of agency programs.

A central accounting office would formulate and enforce a uniform set of state accounting standards, regulate and supervise the accounting function in all government offices and instrumentalities.

There is agreement among private practitioners and government accountants on the positive impact of such an office. One, the office could spearhead the development and modernization of accounting theory and practice more attuned to the development requirements and the unique features of Philippine fiscal administration. Two, it could assume the oversight accounting functions currently exercised by the COA, the BTR, and the DBM. This would rationalize the accounting functions and processes in government, and scrap the present overlapping of functions and jurisdictions among the three offices. In addition, it could lead to the professional development of accounting profession in government.

More importantly, the office could serve as a clearinghouse for financial information for development and fiscal planning, legislation, and accountability purposes. With such an institutional base, accounting and its information could be inputted into institutional mechanism and processes of development administration plans where it usually receives scant mention.

N. Growth of Multinational Corporations (MNCs) and Its Implications

The implications of the proliferation of MNCs and the extent to which their activities have permeated the country's financial and economic life present a challenge to adapt to a new set of economic relationships.

Accounting is encountering new demands particularly in the branch of social accounting i.e., insight into the objectives of MNCs and their contributions, if any, to the host country. Accounting for MNCs has caught the concern of international bodies like the United Nations (UN) and the Orga-

nization for Economic Cooperation and Development (OECD) which have prepared some guidelines regarding the activities of these enterprises specifically on the following issues which have a bearing on accounting management and reporting:[20]

(1) Transfer Pricing

(2) Foreign Currency Transactions

(3) Accounting Policies

(4) Reporting Requirements

(5) Value-added Statements

(6) Employment and Social Welfare Contributions

The UN's Commission on Transnational Corporations (UNCTC) has developed guidelines for disclosure of financial and non- financial data such as: environmental impact statements and employment-generation, among others.[21]

The International Accounting Standards Committee (IASC) of the UN of which PICPA is a member, is a step towards the establishment of a permanent accounting standards body. This is of primary importance to the Third World countries like the Philippines because the IASC provides direction to MNCs with regards to the international standards for disclosure. However, the matter of value-added statements and transfer pricing has not yet been delved into.[22] For the Philippines, these are particularly significant, as value-added statements measure an MNC's performance as to labor and capital.

Like it or not, governments of less-developed countries have extensive dealings with MNC's. The accelerated demands of development expenditures compel LDCs to import more and more from MNCs. State accounting has to devise systems which can help monitor MNC-LDC government relationships and provide necessary financial information for up-to-date evaluation.

O. Regionalization/Internationalization and Its Challenges

The need for countries to establish links among themselves in order to develop and promote their common concerns in accounting is manifested by the establishment of supra-national bodies.

Accounting and financial practitioners and academicians have grouped themselves into numerous regional professional associations, e.g. the ASEAN Federation of Accountants (AFA), the Asian Confederation of Asian and Pacific Accountants (CAPA), the African Accounting Council (AAC) the Inter-American Accounting Association (IAA), the European Union Europeenee des Experts Comptables, Economiques et Financiers (UEC), and the Middle Eastern Accounting Association (MEAA).

Local associations of government accountants like the AGAP and the GACPA can do much to increase their linkages with these international and regional bodies.

Most of these bodies are in the process of devising better regional and international accounting practices, standards and common accounting concepts.[23] While the development of accounting at the national level for domestic use is the more urgent problem, regional accounting should merit some attention because of certain developments which requires its immediate response, e.g. monitoring and regulation of MNC operations in ASEAN countries through accounting.

ENDNOTES

[1]Section 109, PD 1445.

[2]Statement 9.

[3]Statement 69.

[4]Statement 71.

[5]Section 63, PD 1445.

[6]Statement 40.

[7]Statement 107.

[9]Article 3, Government Accounting and Auditing Manual (GAAM), Vol. I (COA Circular No. 91-368, December 1991), pp. 80-83.

[10]Section 2, P.D.1177.

[11]Adolf J.H. Enthoven, Accounting Education: Its Importance and Requirements, Fifth International Conference on Accounting Education, Mexico, October 1982, p. 4.

[12]Gregorio S. Licaros, "Professional Solidarity." A Speech delivered at the General Membership Meeting of the Philippine Institute of Certified Public Accountants on June 20, 1980 and published in the Accountant's Journal, Vol. 30, Nos. 1-2, 1980, p. 26.

[13]Enthoven, p. 5.

[14]Ibid., p. 29.

[15]Statement 72.

[16]Statement 73.

[17]Enthoven, p. 5.

[18]*Ibid.*

[19]*Ibid.*, p. 6.

[20]*Loc. Cit.*

[21]Eduardo C. Gopez, Governmental Auditing: Concepts and Practices, First Edition, (Makati, Metro Manila: La Marinella, 1978), p. 216.

[22]Leonor M. Briones, "Towards Integrated Training in State Accounting and Auditing: The Philippine State Accounting and Auditing Center," article for publication in International Journal of Government Accounting, U.S.A.

[23]Enthoven, p. 23.

Annex I

NATIONAL GOVERNMENT AGENCY
BALANCE SHEET*
As of December 31, 19___
General Fund

ASSETS

Current Assets		
Cash	xxx	
Receivables	xxx	
Inventories	xxx	
Total Current Assets		xxx
Other Assets		xxx
Contingent Assets		xxx
Investments and Fixed Assets		
Investments	xxx	
Acquired Assets	xxx	
Land and Land Improvements	xxx	
Buildings and Structures	xxx	
Furniture, Fixtures, Equipment, Work Animals and Books	xxx	
Total Investments and Fixed Assets		xxx
TOTAL ASSETS		xxx

LIABILITIES

Current Liabilities		
Payables	xxx	
Trust Liabilities	xxx	
Depository Liabilities	xxx	
Deferred Credits	xxx	
Total Current Liabilities		xxx
Contingent Liabilities		xxx
Long-Term Liabilities		xxx
TOTAL LIABILITIES		xxx

RESIDUAL EQUITY

Cumulative Results of Operation:		
Per Statement of Operations	xxx	
National Clearing Account	xxx	
Total Cumulative Results of Operations		xxx
Invested Capital		xxx
Contingent Capital		xxx
TOTAL RESIDUAL EQUITY		xxx
TOTAL LIABILITIES AND RESIDUAL EQUITY		xxx

CERTIFIED CORRECT:

_____
Chief Accountant

*Prescribed under COA Circular No. 91-368, as amended.

Annex II

NATIONAL GOVERNMENT AGENCY
STATEMENT OF OPERATIONS*
For the Year Ended December 31, 19___

GENERAL FUND

Cumulative Results of Operation (CRO) at the Beginning of the Year		
Continuing Appropriations	xxx	
Overdraft in Appropriations	(xxx)	xxx
ADD: Allotments Received During the Year		
Republic Act No. _____	xxx	
Others (Specify)	xxx	xxx
Total Allotments During the Year		xxx
Less: Obligations Incurred During the Year		
Personal Services	xxx	
Maintenance and Other Operating Expenses	xxx	
Capital Outlays	xxx	xxx
Excess of Allotments Over Obligations Incurred		xxx
Add: Income	xxx	
Grants and Aids	xxx	
Extraordinary Receipts	xxx	
Borrowings	xxx	
Adjustments - Additions or (Reductions)	xxx	xxx
Total CRO During the Year		xxx
Less: Reversions to CRO - Unappropriated		
Income	xxx	
Grants	xxx	
Extraordinary Receipts	xxx	
Borrowings	xxx	
Unepended Balance of Allotments	xxx	
Adjustments - (Additions) or Reductions	xxx	xxx
CRO at the end of the Year		
Continuing Appropriations	xxx	
Overdraft in Appropriations	(xxx)	xxx

CERTIFIED CORRECT:

_____
Chief Accountant

*Prescribed under COA Circular No. 91-368, as amended.

Annex III

LOCAL GOVERNMENT UNIT
BALANCE SHEET*
As of December 31, 19___

GENERAL FUND

ASSETS

Current Assets:	
Cash	xxx
Receivables	xxx
Inventories	xxx
Miscellaneous Assets & Deferred Charges	xxx
Total Current Assets	xxx
Contingent Assets:	
Contingent Assets	xxx
Total Contingent Assets	xxx
Investments and Fixed Assets:	
Investments	xxx
Acquired Assets	xxx
Fixed Assets - Land and Land Improvements	xxx
Fixed Assets - Buildings and Structures	xxx
Fixed Assets - Furniture, Fixtures, Equipment, Work Animals and Books	xxx
Total Investments And Fixed Assets	xxx
TOTAL ASSETS	xxx

LIABILITIES

Current Liabilities:	
Payables	xxx
Obligations Incurred	xxx
Obligations Liquidated	xxx
Trust Liabilities	xxx
Depository Liabilities	xxx
Deferred Credits	xxx
Total Current Liabilities	xxx

*Prescribed under COA Circular No. 91-368, as amended.

Contingent Liabilities:	
Contingent Liabilities	xxx
Total Contingent Liabilities	xxx
Long-Term Liabilities:	
Public Debts	xxx
Total Long-term Liabilities	xxx
TOTAL LIABILITIES	xxx

RESIDUAL EQUITY

Cumulative Results of Operation (See Statement of Operations)	xxx
Invested Capital	xxx
Contingent Capital	xxx
RESIDUAL EQUITY	xxx
TOTAL LIABILITIES AND RESIDUAL EQUITY	xxx

CERTIFIED CORRECT:

_____

Accountant

Annex IV

LOCAL GOVERNMENT UNIT
STATEMENT OF OPERATIONS*
For the Year Ended December 31, 19___

GENERAL FUND

INCOME:	
Tax Revenue	xxx
Operating and Miscellaneous Revenue	xxx
Capital Revenue	xxx
TOTAL	xxx
GRANTS AND AIDS	xxx
EXTRAORDINARY RECEIPTS	xxx
BORROWINGS	xxx
TOTAL INCOME, GRANTS AND AIDS, EXTRAORDINARY RECEIPTS AND BORROWINGS	xxx
DEDUCT: EXPENDITURES UNDER CURRENT YEAR'S APPROPRIATIONS	
Personal Services	xxx
Maintenance and Other Operating Expenses	xxx
Capital Outlay	xxx
TOTAL	xxx
EXCESS (DEFICIT) OF INCOME OVER EXPENDITURES	xxx
ADD: TRANSFERS (ADDITION)	
Interfund Transfers	
From General Fund	xxx
From Special Education Fund	xxx
Interlocal Government Transfers	
From Provincial Governments	xxx
From City Governments	xxx
From Municipal Governments	xxx
From Barangay Governments	xxx
ADJUSTMENTS (ADDITION)	xxx
EXCESS (DEFICIT) OF INCOME OVER EXPENDITURES TRANSFERS, TRANSFERS AND ADJUSTMENTS	xxx
DEDUCT: TRANSFERS (REDUCTION)	
Interfund Transfers	
To General Fund	xxx
To Special Education Fund	xxx
Interlocal Government Transfers	
To Provincial Governments	xxx
To City Governments	xxx
To Municipal Governments	xxx
To Barangay Governments	xxx
ADJUSTMENTS (REDUCTION)	xxx

*Prescribed under COA Circular No. 91-368, as amended.

RESULTS OF CURRENT YEAR'S OPERATIONS	xxx	
ADD: NET OF UNEXPENDED PRIOR YEAR'S APPROPRIATIONS		
PRIOR YEARS' CONTINUING APPROPRIATIONS		
Unexpended Allotments	xxx	
Legislative Appropriations Unallotted	xxx	
Receipts Automatically Appropriated Unallotted	xxx	
Total	xxx	
Less: Reversion of Continuing Appropriations	xxx	
TOTAL	xxx	
LESS: EXPENDITURES CONTINUING APPROPRIATIONS		
Personal Services	xxx	
Maintenance and Other Operating Expenses	xxx	
Capital Outlay	xxx	
TOTAL	xxx	
NET OF UNEXPENDED PRIOR YEARS' APPROPRIATIONS		xxx
TOTAL RESULTS OF OPERATIONS		xxx
ADD: CUMULATIVE RESULTS OF OPERATIONS AT THE BEGINNING OF THE YEAR		xxx
Unappropriated Balance		xxx
Reversion of Continuing Appropriations		xxx
TOTAL CUMULATIVE RESULTS OF OPERATIONS		xxx
ADD: EQUITY RESERVES, END OF THE YEAR		xxx
CUMULATIVE RESULTS OF OPERATONS, BALANCE END OF THE YEAR		xxx
CUMULATIVE RESULTS OF OPERATIONS BREAKDOWN:		
Unappropriated		xxx
Reserves		xxx
Appropriated		xxx
Unexpended Allotments		xxx
Legislative Appropriations Unallotted		xxx
Receipts Automatically Appropriated Unallotted		xxx
Overdraft in Appropriations		xxx
TOTAL		xxx

CERTIFIED CORRECT:

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Accountant

PART VI

STATE AUDITING

CHAPTER 18

STATE AUDIT IN THE PHILIPPINES

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STATE AUDIT IN THE PHILIPPINES

I. THE NATURE OF STATE AUDITING

State audit is an ancient and respected branch of state administration.[1] In ancient Mesopotamia, royal scribes inventoried granaries to check on storekeepers.[2] In the old Greek city- states, to give a public account of one's stewardship of office was a part of official duties.[3] And in Asia, the Chinese emperors appointed high officials with royal authority to review the performance of local officials.

In time, state audit developed from the need for good government. It evolved from a simple device to prevent ruin in public finances and chaos in public bookkeeping to an instrument for ensuring open, regular, efficient, and responsive government.[4] State audit thus became closely intertwined with modern government and public accountability.

Definition

Auditing, in a general sense, is a systematic and critical evaluation of the financial position, operating systems, and results of operations of an audited entity. A widely accepted definition of auditing is as follows:

> *"A systematic process of obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested user."*[5]

Such definition embraces private or commercial, internal, state or governmental and other types of audit.

State audit is mainly defined by constitution and law. In the Philippines, state audit is defined by the "Government Auditing Code of the Philippines (Presidential Decree No. 1445) as:

> *"the analytical and systematic examination and verification of financial transactions, operations, accounts, and reports of any government agency for the purpose of determining their accuracy, integrity, and authenticity, and satisfying the requirements of law, rules, and regulations."*

State audit relies on the provisions of law; its authority and limitations are prescribed by law and it is conducted in accordance with law.[6] The 1987

Constitution and related laws set the scope, powers, functions, and jurisdiction of government auditing. All such laws pertaining to government accounting and auditing, as well as modern principles of audit policy and practice have been codified into the Code which took effect on August 7, 1978.

Auditing in Public Administration

It is difficult to imagine a well-functioning, satisfactory system of public administration without the rigorous public accountability that state audit ensures. The concept and raison d'etre is inherent in public fiscal administration as the management of public funds is a trust. State audit is not an end in itself but an indispensable part of a control and accountability system whose aim is to reveal and correct deviations from accepted standards and principles as prescribed by law and tradition. Thus, in public administration, state audit occupies a critical role as a component of the fiscal administration cycle.

State auditing (along with accounting) may be considered as the control and accountability component of the fiscal administration cycle. As a control mechanism, auditing ensures the proper and legal utilization and management of fiscal resources in accordance with sound financial management principles, accounting and auditing standards, and applicable laws and regulations.

As an accountability component, it seeks to ensure that public officials entrusted with functions and resources are made responsible for the performance and results of operations of their office. Reports on the financial operations of agencies and their performance are prepared by COA auditors and submitted to the President and Congress. These are also made available to the public.

In the fiscal administration cycle, auditing also provides inputs to the next phase which is planning. Audit reports contain vital information on the results of operations of agencies and recommendations to improve their performance. For agency officials, these information are useful in formulating subsequent plans and targets. The Department of Budget and Management, which is a resource control agency, refers to audit reports in reviewing budget proposals of agencies. The Congress also uses audit reports in reviewing agency budgets proposed in the General Appropriations Bill.

Auditing certainly can influence profoundly government operations and performance and its development efforts. It remains for policymakers and the people to appreciate the potentials of auditing as an active partner for national development.

Auditing and Accounting

Auditing is closely intertwined and thus oftentimes confused with accounting. In fact, auditing evolved from accounting. In modern times, however, auditing has become a separate field of theory and practice. It is an independent discipline which relies upon the results of accounting data.[7] Accounting is a discipline which provides financial and other information essential to the efficient conduct and evaluation of the activities of an organization.[8] Accounting is thus concerned with constructing from a mass of transactions entered into by a firm or agency during a certain period, financial statements, results of transactions (in terms of profit and loss), and current financial position, through interpretation, summarization, and compilation of information. On the other hand, auditing is primarily concerned with analyzing whether or not the financial statements reasonably represents the results of the firm's operations. Accounting is constructive; auditing is analytical.[9] While accounting involves the creative generation of financial and other data, auditing is a critical generation of judgmental information.[10]

HISTORY OF AUDITING IN THE PHILIPPINES

1. Before Political Independence[11]

a. Auditing Under Spain

It is interesting to note that audit systems of countries which have colonial histories tend to have one common characteristic: these were installed by the colonizer and tend to reflect to a greater or lesser degree features of the audit system in the "mother country". Such audit systems were transplanted as part of administrative systems which were artificially, if not forcibly, imposed on a colony. This is not to say that there was nothing of audit or of administrative systems before Western colonizers came with the sword and cross. It was standard practice for conquering hordes to totally destroy whatever records existed and to obliterate evidence of earlier cultures.

Thus, accounts tracing the history of auditing in the Philippines invariably start with the Spanish regime which consolidated its rule over various scattered small kingdoms and gave the name Filipinas or Philippines to its domain. Earliest available written records start with the Spanish colonial period which lasted from the 16th to the 19th century. However, if archaeologists are to be believed, current findings tend to indicate fairly extensive kingdoms which would include audit activities in one form or another and with varying degrees of sophistication.

The first known activity in the Spanish colonial government which can presently be described as "auditing" was in 1653 when a Royal Audiencia or a high court of justice was set up in the capital city of Manila. Fiscal review was conducted by the audiencia in addition to regular judicial functions. This later evolved into a separate and independent fiscal control activity in 1739 with the establishment of the royal exchequer or a national treasury. The decree creating the royal exchequer specified that the books of accounts of the treasury should be certified by a contador or accountant, and by the oidor,a representative of the Spanish crown whose duties can be considered as forerunner of the modern auditor's.

By the middle of the nineteenth century, auditing was conducted by a judicial body called the Tribunal de Cuentas or Court of Accounts. The type of audit activity engaged in was to a large extent comparable to a detailed post-audit of transactions.

b. Auditing under the Malolos Republic[12]

Accounts tracing the history of auditing in the Philippines start with the Spanish period and move on to the American period without touching on the Filipino revolutionary government which was established at the time the Americans came. The following is an attempt to fill in that historical gap.

As in all colonial regimes, Spanish rule in the Philippines was far from peaceful. Its three-century regime was marked with over three hundred recorded revolts, culminating in the revolutionary movement of the Katipunan. The Katipunan movement which started in nine provinces in Luzon quickly spread to the rest of the country, resulting in a decisive victory over the Spaniards by 1896. An independent Philippine republic was declared and a constitution was drawn up, known as the Malolos Constitution. Title XII of the Constitution was devoted in its entirety to the "Administration of the State". The budget process was described in detail. Apparently, the budgets were subject to the public scrutiny. One particularly interesting portion of the charter specifically provided that the budgets should be published. Various decrees were also issued on the administration of the fiscal system. While the Malolos Constitution itself was silent on the function of auditing, Rule No. 40 of the Decree of June 20, 1898 provided that the tax collectors should render an accounting of all expenditures as well as all tax collections made which were to be verified by the Assembly. It appears from available literature that the function of verification was lodged in the Assembly which passed on the proposed budgets of expenditures and income. The legislature type of audit, therefore, was used under the first Philippine Republic.

However, the Republic (now known as the Malolos Republic) was short-lived. Rather than surrender to the Filipino revolutionaries, the beleaguered Spanish government negotiated with the Americans who were then awaiting the outcome of hostilities. For US$20 million, Spain ceded the Philippines to the United States. The latter then proceeded to establish its rule over the islands after a long drawn-out and bitterly bloody war.

c. Auditing under the Americans

When the Americans took over the Philippines on August 13, 1898, one of the first steps undertaken was an inventory of all public funds. Thus, one of the earliest positions created was that of Auditor. On September 5, 1898, the position of Auditor of the American military government was established. In the next thirty-seven years, the office eventually became the Bureau of Audit after a series of reorganizations.

During the American rule, a shift was made from the judicial type of audit institution started by the Spaniards and the legislative type initiated under the short-lived Malolos Republic to the executive type of auditing functions. It was during this period that the practice of pre-audit was initiated. The very first regulation on auditing which was passed during the American occupation specified that the auditor should countersign all warrants for withdrawal of money from the National Treasury. Later, this control measure was tightened even more with the innovation that all disbursements, whether by treasury warrants, bank checks or in currency should be approved by the Auditor. Likewise, deliveries had to be inspected and approved by the Auditor. While the circumstances under which pre-audit was installed have long since changed, the practice persisted. It was only after 1975 that efforts were exerted to withdraw from pre-audit in a deliberate and systematic manner.

d. Auditing under the Commonwealth Period

As a preliminary step toward the grant of full political independence from the United States, the Philippines was transformed into a Commonwealth in 1935. Among the many developments during this period, three major events were of particular significance to Philippine state auditing: the drawing of the Constitution of 1935 which provided for an independent General Auditing Office, the passage of Commonwealth Act No. 320 which combined both the accounting and auditing functions under the GAO, and the passage of Commonwealth Act No. 325 which conferred on the GAO the function of auditing public service enterprises.

e. Some observations on auditing systems prior to political independence

The Philippines formally declared its political independence from the United States in 1946. Earlier, apart from the short- lived Mololos Republic, the Philippines had been under Spanish rule and American tutelage, first as a colony directly administered by the Americans and later as a Commonwealth. The external form of auditing had been different. Thus, under the Spaniards, a judicial type of body was created while under the Americans, an executive type of audit system was installed. However, the objectives and even the impact of such systems were similar. These auditing systems were set up as a part of the colonial regime and the perspective was from the point of view of the colonial power. These constituted an important part of the package of administrative measure designed to enhance the interests of the colonial powers. It cannot, therefore, be said that such audit systems were helpful in "national development." During the American period, the Auditor was appointed by the President of the United States and reported directly to him. In the audit systems installed, both the Spaniards and the Americans were designated to provide financial information which would serve their own information needs and strengthen their respective colonial regimes.

With this perspective in mind, the circumstances under which pre-audit was installed by the American regime can be understood. Many writers have noted that the audit system introduced by the Americans was of the "executive type." The system of pre-audit introduced by them served more as an internal control measure designed to keep a close tab on colonial affairs than as a system of evaluation and review. Unfortunately, even when the Philippines became a Commonwealth and later on an independent republic, the system of pre-audit persisted.

2. The Post Independence Period

In 1946, the Philippines formally regained its political independence from the United States. However, the administrative system that was installed was no different from the system earlier established during the period of colonization and of tutelage as a Commonwealth. The same was true for auditing. According to one author, "the Philippines adopted in full the auditing system built during more than fifty years of American administration."[13] While the Philippines made the formal transition to political independence, the administrative machinery that was installed was essentially the same machinery that existed fifty years earlier. It was inevitable that problems would ensue, considering that a system initiated during colonial times

could not possibly be an effective instrument under conditions of political independence.

During the early 1950's, the Philippines was confronted with a severe political, economic and social crisis. Economic and social problems which started during the colonial days had by then escalated to crisis proportions. The very foundations of Philippine society were challenged. Alarmed, U.S. President Truman sent an Economic Survey Mission headed by Daniel Bell in 1950. The U.S. has always maintained a special interest in the Philippines in the light of the past colonial relations, economic interest, and the strategic location of the country in Asia. Among others, Bell strongly recommended reforms in public administration, including modernization of fiscal administration, to help government cope with worsening political and economic problems. Implementation of administrative reforms was part of the precondition for the grant of further foreign aid. A commission on reorganization, the Government Survey Reorganization Commission (GSRC) was set up with assistance from the American government in the form of consultancy services from two management firms. The objective was to evaluate the entire governmental system and make recommendations for reforms.

a. The First Reorganization Effort: Reforms with Assistance of American Consultants

It was under this scenario that the first attempt to link auditing with national development was made. In 1954, a modernization project in auditing was initiated upon the advice of the American consulting firm, Booz, Allen and Hamilton, one of the two consulting firms engaged for the reorganization of the governmental system. It should be emphasized that these attempts at auditing reforms were not exercised in isolation. These were part of the reform efforts which were sweeping the entire administrative system, carried on with the assistance of American consultants as part of the response to a very real and serious threat to the existing government.

During this period, the then GAO was reorganized twice. In 1953, Republic Act No. 837 was passed, standardizing and upgrading the salary scales of personnel. In 1957, Republic Act No. 1890 was passed providing for an organizational restructuring of the GAO.

However, this period of American consultancy will perhaps be remembered for three major shifts in audit thought. For the first time since auditing was practised in the Philippines, a serious, deliberate effort was made to link auditing with the process of national development. This is really not quite surprising because the environment at that time was very receptive to such concerns. It was increasingly recognized even by other countries that

administrative systems set up during colonial period were not responsive to the multifarious problems of newly emerging nations. Much interest and energy were focused on national development and the role of public administration in attaining development goals. During this period, national development was measured in terms of economic development. It was during this time that the Institute of Public Administration in the Philippines was set up, with the cooperation of the University of the Philippines. One of the earliest outputs of the Institute was a textbook on public fiscal administration which included a section on accounting and auditing. At this time, auditing ceased to be considered an end in itself. It was considered as a vital part of the total administrative effort to attain specific development goals. Auditing practices and the entire audit organization were reexamined in the light of increasing demands for efficiency in government for the attainment of development goals.

The above shift in thinking on the role of auditing paved the way to a serious reexamination of the pre-audit system. This led to the second major shift in auditing thought and practice: recognition of the need to withdraw from the practice of pre- audit and to establish a system of post-audit. At this time, pre-audit had been in practice for fifty-six years and was well-entrenched. In spite of the obvious merits and advantages of the post-auditing system, it could not be implemented in full. Resistance not only to post-audit but to the entire package of administrative reforms initiated at the time was tremendous. Understandably, the reforms recommended not only had implications for organizational restructuring but touched on the political system as well. Problems of operationalizing the concept of post-audit cropped up. At the same time interrelated problems of developing new skills, new systems and new organizational structure arose. While there was tremendous pressure to organize the entire governmental system as a response to the political and economic crisis of that time, bureaucratic resistance to change, as well as built-in difficulties in the political system, were just as formidable. Still, this period can be considered significant for auditing in the sense that the first difficult and controversial steps were undertaken at this time.

Recognition of the need to shift to a system of post-audit led to the third major shift in auditing thought during this period: concern with program audit in terms of results vis-a-vis objectives. Earlier, because of the predominance of pre-audit, auditing work was based on object of expenditure, just like line-item budgeting. The shift in thinking towards post-audit led to the realization that instead of object of expenditure, programs themselves should be evaluated and audited in terms of results. This kind of thinking was matched by a similar development in budgeting which called for the performance type of budget and not the line item. The idea led further on to the

creation of a new department in the GAO, the Program Audit Department, which served as the predecessor of the Performance Audit Office and the present Special Audit Office.

b. Reforms under the second reorganization effort

During the sixties, administrators attempted to implement the changes proposed during the Fifties as advised by the American consultants. There were varying degrees of success and failure. Many of the innovations proposed, including those concerning auditing, demanded no less than a corresponding restructuring of the government's organizational system. Unfortunately, Congress rejected many of the reorganization plans presented in 1955 and 1956. Out of the fifty plans presented in 1955, only one was approved and passed into law; out of the fifty-three plans presented in 1956, twenty-one were rejected. For those plans which were passed into law, complicated problem of implementation cropped up.

In auditing, difficulties were met in the effort to shift to post-audit. These were technical, organizational, as well as political. It was not an easy task to reverse over fifty years of auditing tradition and practice. Reformers realized that administrative, technical, and even political preconditions had to be met before pre-audit could be phased out. Firstly, post- audit is predicated on the existence of strong internal control systems. Secondly, government agencies had to accept the fact that fiscal responsibility rested solely on them, and should not be shared with the auditor. Thirdly, since pre-audit was considered as a response to the constitutional mandate of preventing "irregular, unnecessary, excessive or extravagant expenditures or uses of funds and property," policymakers still had to be convinced that such a function could be fulfilled even without pre-audit.

There were difficulties in the other administrative fronts as well. In the meantime, politico-economic problems were building up and the threat of social upheaval loomed once more. One of the targets of mounting criticism was the administrative system. This led to the second post-war reform effort which directly affected auditing. The Presidential Commission on Reorganization (PCR) was formed during the late sixties. One of the major concerns, as expected, was the fiscal administrative system which included auditing. Quite reasonably, this development can be described as the second deliberate effort to link the administrative system, including auditing, with national development goals. Not surprisingly, however, the proposed reorganization plan met with opposition in Congress.

One of the most significant changes during the Martial Law era which greatly affected state auditing was the change in the Constitution. The 1935 Charter was often criticized for the absence of a clear, definite provision for the independence of the General Auditing Office. It was really the intention

of the framers of the 1935 Charter to make the GAO an independent auditing body, as evidenced by their recommendation for the creation of an "independent auditing office under the direction and control of the Auditor General." The special committee on style, however, considered the word "independent" redundant since independence was already implied in the provision that the Office was to be under the direction and control of an auditor general.[14] The omission eventually led to doubts and confusion as to the powers and jurisdiction of the GAO. The framers of the 1973 Constitution, taking note of this deficiency, decided to give due emphasis on the independence of the Commission on Audit. Thus, paragraph (1), Section 1, Article XII-D of the 1973 Constitution (maintained in Section 1, Article IX-A, of the 1987 Constitution, and the succeeding sections) provided for an "independent Commission on Audit."[15]

Another important development in state auditing under the 1973 Constitution was the reorganization of the Commission on Audit from a constitutional institution headed by one person, the Auditor General, to a commission type of organization, headed by the Chairman and two Commissioners. This change was provided for in the 1973 Constitution which was ratified on January 17, 1973. Memorandum Circular 619 was issued on January 26, 1973 prescribing guidelines for the reorganization of the GAO. This was followed by Presidential Decree No. 111 which declared the effectivity of the creation of the Commission on Audit, and P.D. 111-A which provided for organizational changes in the light of the new set-up. This development was part of the continuing effort and concern to uphold and strengthen the independence of the organization as a constitutional body. Presumably it was believed that it would be more difficult to pressure three persons than just one man.

It bears repeating that if the specific period when the efforts were made to link auditing with national development were to be identified, the period of the early Fifties could be pinpointed. This was when post-audit was first considered as a more effective means of evaluating the attainment of development goals. The concept of program audit was also introduced at this time. Prior to this period, with the exception of the short- lived first Filipino republic, the audit system was part of the control measures designed to facilitate control over the activities of colonial administrators. However, the effect of efforts to promote post-audit at that time were limited, considering the difficulties of changing well-entrenched practices and the political environment which did not fully appreciate the merits of the "new" concept of post-audit. It took a much more drastic reorganization process in 1975 to dramatize the need for a new and expanded role for auditing in national development.

c. Summary of changes prior to 1975

It might be helpful to summarize at this point the major changes in organizational and operational aspects of state audit in the Philippines up to 1975, thus:

Forms of Organization/
Location in Government Primary Auditing

Period	Set-up	Activity
Spanish Period	Juicial-type Court of Accounts	Detailed post audit of transactions
First Filipino Republic	General Assembly	Post-audit of transactions
American Regime: : as colony	Bureau under the Governor General	Pre-audit of all transactions
: as Commonwealth	Independent Constitutional body	- do -
Post Independence: :early period	- do -	- do -
: the Fifties	- do -	Partial lifting of pre-audit Start of limited program audit
: early Seventies	Change to Commission-type of organization	Further lifting of pre-audit Expansion of program audit

II. TYPES OF AUDIT

The various types of state audit may be broadly classified as to: timing, organizational status, and scope.

A. Timing

In terms of timing, there are two main types: pre-audit and post-audit. Some authors would include a third type --continuous audit.[16]

In pre-audit, the auditor reviews a transaction (a contract for janitorial services, for example) even before such services are rendered. The auditor also gives his tentative approval for payment of the services by the agency. Under post- audit, the auditor reviews and approves the transaction after the services have been rendered and payment has been made.

In both cases, the review may consist of: a) determining whether all relevant laws, rules and regulations have been observed in the transaction; b) physical inspection of supplies or equipment; c) checking whether all necessary documents are submitted and properly accomplished; d) determining whether the required authority or approval has been secured; and e) checking mathematical accuracy.[17]

B. **As to Organizational Status of Auditor**

There are two main types of state auditing as to organizational status of auditor: a) internal audit, and b) external audit.

Internal audit is mainly a management tool for control and evaluation of agency operations. It is sometimes referred to as "management audit" and considered a part of the internal control system of an agency. Thus, it is basically a continuing management task performed by management personnel. Its objectives are to achieve regularity, efficiency, economy, and effectiveness in agency operations, especially in large organizations.

The internal auditor undertakes an analytical review of balances disclosed in the financial statements to determine that the information contained in the statements is consistent internally, with budget accounts, and with those of prior years. He may also assist, in an advisory capacity, in adopting basic organizational regulations, preparing rationalization proposals, and recommending measures to improve the structural and procedural systems of the agency.

In small agencies, the internal audit is usually conducted by accounting or controller units; in large organizations, it is done by a separate internal audit staff which reports directly to the head of agency, the finance office, or corporate board of directors, in the case of corporations.

The audit activities of the internal auditor may be considered as a form of pre-audit, and under the concept of fiscal responsibility is the primary function of agency management; thus, internal audit becomes an indispensable tool for exercising such responsibility. As a consequence of the partial lifting or withdrawal of pre-audit by the then General Auditing Office (GAO)

in the early 1960s, internal audit was made a part of agency internal control systems. Republic Act No. 3456 ("Internal Auditing Act of 1962") was enacted to provide for the creation of internal audit services in all departments, bureaus and offices of the National Government. Republic Act No. 4177, enacted in 1965, expanded the coverage of R.A. 3456, to include all branches, subdivisions and instrumentalities of the government, and government-owned and/or controlled corporations. The internal audit service units (IAS) were placed under the direct supervision and control of the head or assistant head of agency. The GAO was also mandated to promulgate and enforce general policies, rules and regulations on internal auditing.[18] The COA continues to support the conduct of internal audit as part of its efforts to assist agencies put up internal control systems. It has required heads of auditing units to monitor compliance with Administrative Order No. 278 s. 1992 of the President, directing the strengthening of the internal control systems of government agencies and the organization of IAS.

The establishment of internal audit units, however, has been rather slow. One reason is the lack of personnel adequately trained in internal control functions. Another reason is the agency perception that internal audit is but a duplication of COA audit.[19] In some respect, this perception is a valid one and the challenge is close coordination between internal audit units and external auditors (of the COA) to avoid duplication of functions and achieve common audit objectives. Another is for the agencies to appreciate its beneficial effect on agency operations and performance.

The establishment of internal audit units must fulfill certain principles. The units should be granted a measure of independence from offices under its audit; they should report directly to the highest level of authority. They should be authorized to examine any and all areas pertinent to the scope and objectives of internal audit, granted access to all relevant information and cooperation, and staffed with adequate number of personnel with appropriate qualifications and remuneration. Finally, in designing a particular model of internal control system, attention should be paid to its costs and benefits so as to ensure that the resulting system is cost-effective.

External audit, on the other hand, is performed by auditors external to or independent of the audited organization. In the Philippine state audit context, it is the audit performed by the COA auditors; in commercial audit, it is conducted by independent certified public accountants on private business organizations primarily to express an opinion on the fairness, consistency, and conformity of financial statements to generally accepted accounting principles, for submission to management, government regulatory agencies, stockholders, and other interested parties.

Under the Constitution, external audit by the COA can not be replaced by internal audit (or any private external audit). While an internal auditor may

conduct audit of his agency (or private independent auditors perform external audit), only the COA auditor is authorized to conduct government audit.

Like internal audit, its scope of work may relate to financial, compliance, efficiency, economy, and effectiveness of agency financial transactions and operations. Unlike internal audit, it is called upon to give a professional opinion on the fairness of presentation of financial statements.

External audit as performed by the COA includes a comprehensive review of an agency's internal audit services, as part of its audit function of evaluating agency internal control systems. The COA's concern over the quality of internal control systems is based on the fact that the scope and thrusts of external audit is dependent on the adequacy and effectiveness of internal audit services. Where internal audit is adequate, the scope of COA audit can be limited to selective checks on agency internal control systems. The Constitution provides that where the internal control system of audited agencies is inadequate, the COA may adopt such measures, including temporary or special pre-audit in order to correct agency deficiencies.[20]

C. **As to Audit Scope**

Fiscal Audit: Financial And Compliance

Fiscal audit is the "traditional financial audit" in government. It is a combination of financial audit and compliance audits.[21]

Financial audit is the most widely practised type of audit in the private sector. It is performed primarily through an examination of financial statements in order to express an opinion on the fairness with which the financial condition and results of operations of an audited entity are presented.[22] In the government, financial audit is required by the Constitution.[23] Also, it is implied in the Constitutional provision[24] requiring the COA to submit an annual report on the financial condition and operation of the national government and its subdivisions, instrumentalities, and agencies, including government corporations.

Financial audit of government transactions is conducted to determine whether:

a) financial operations are conducted in accordance with applicable laws, rules and regulations, and accounting and auditing standards; and

b) whether agency financial statements present fairly and accurately the financial position of the agency in accordance with generally accepted accounting principles.

The auditor determines whether the agency is maintaining effective control over revenues, expenditures, assets and liabilities, whether financial statements are fairly presented, and if financial reports contain accurate, reliable and useful information.[25]

Compliance audit, on the other hand, is an evaluation of the extent to which the agency has complied with pertinent laws, polices, and rules and regulations in the conduct of its operations. The auditor tests the agency's financial transactions and specific program, function or activity to determine their legality or regularity. He may for instance, check whether the agency has not violated pertinent laws in incurring significant unrecorded liabilities.[26]

Performance Audit: Efficiency, Economy, Effectiveness

A performance audit is a constructive examination and evaluation of the financial and operational performance of an organization, program, function or activity with the objective of identifying opportunities for greater economy, efficiency, and effectiveness in agency operations.[27] It entails a broad review and diagnosis of agency policies, organization, and operations. It includes comparison of plans with accomplishments, results with targets and standards, practice with policy.[28] As an evaluative (as opposed to investigative) process, performance audit emphasizes the identification of problems and the formulation of appropriate solutions for their correction. The auditor recommends such measures as to improve economy, efficiency and effectiveness.

Thus, performance audit invariably entails economy, efficiency, and effectiveness audits.

Economy and efficiency audits determine:

a) whether the agency is managing and utilizing its resources (personel, property, funds) economically and efficiently;

b) the causes of inefficiencies or uneconomical practices;

c) whether the agency has complied with laws and regulations concerning matters of efficiency and economy.[29]

Effectiveness or "program results" audit determines:

a) whether the desired results or benefits established by the legislature or other authorizing body are being achieved; and

b) whether the agency has considered alternatives that might yield desired results at a lower cost.

Peformance audit is conducted on the basis of Section 4, Article IX-D of the Constitution which requires that the COA shall "recommend measures necessary to improve their [agencies'] efficiency and effectiveness." It is held that such recommendations can only be generated through the conduct of performance audit. Another statutory basis is found in the State Audit Code which declares it a state policy that government resources be managed and safeguarded "with a view to ensuring efficiency, economy, and effectiveness in the operations of government."

Special/Other Audits

Subsidy Audit (in the Constitution, PD 1445)

Levy Audit (-do-)

III. THE AUDIT PROCESS

A. The Audit Cycle

The state audit cycle consists of six phases:

Phase I. Preliminary survey of the agency or audited entity;

Phase II. Review of the legal and policy framework within which the agency operates, and the plans, policies, objectives, policies, and standards it has adopted;

Phase III. Review and evaluation of the agency's internal control system;

Phase IV. In-depth examination of critical areas, analyses, and evaluation;

Phase V. Preparation of draft report and presentation to agency officials;

Phase VI. Finalization of report; and

Phase VII. Follow-up on the implementation of audit recommendations.

Phase I. Preliminary Survey

The preliminary survey is conducted to acquire a working knowledge of the audited agency and its legal, policy, and administrative environment. The

auditor gathers general background information on the agency and its operations after which he defines the scope of his audit.

The auditor may perform the following activities:

a) interviews with agency officials to obtain general information;

b) obtain basic documents on agency activities, objectives, policies, standards, procedures, etc.;

c) physical inspection of agency facilities, offices, etc.

Ideally, the survey should provide information on:

a) Laws, policies, and rules and regulations applicable to the agency;

b) Brief history and goals or purposes of the agency;

c) Agency organization, functions, staff, regional offices, and operating systems;

d) Nature, investments and location of agency assets;

e) General objectives and policies;

f) Operating methods and standards used in measuring or evaluating agency operations and performance, if any;

g) Description of major, existing problems; and

h) Copies of internal agency reports, especially internal audit reports.

All these documents comprise the permanent file on the agency. Where copies of certain documents are not available, the auditor takes note in his working papers on their existence and availability for future reference when and if he wishes to examine them.[30]

Phase II. Review Of Legal And Policy Framework

In this phase, the information gathered from the preliminary survey are reviewed in order to obtain a general knowledge of the legislation and policies applicable to agency objectives, policies, programs, and operating standards.

The auditor establishes the reason for the creation of the agency, its history, delegated authorities, principal functions and responsibilities, any

legal or policy restrictions imposed on its operations, and the sources and methods of its finances.[31]

In the course of his review, the auditor notes, among others, any failure on the part of the agency to exercise a delegated authority or any exercise of authority which exceeds the limitations imposed on it. In any case, the auditor has to take into account the spirit or intent of the law.

Where legislation or policies are vague and indefinite, or the agency objectives, policies, and standards are not clearly defined or established as is often the case, the auditor must interview agency officials.[32]

Phase III. Review and Evaluation of Internal Control System

In this phase, the auditor reviews the procedures and practices actually applied by the agency in processing its transactions in order to establish:

a) the actual means and methods of carrying out operations;

b) appropriateness and utility of various steps in the processes;

c) the results of operations or transactions relative to agency objectives, legal and policy requirements, and standards; and

d) the effectiveness of the internal control system and its various components.

The review and evaluation of the agency's internal control system is to:

a) identify major critical areas that would warrant more detailed examination; and

b) to determine the type of tests to be used in the closer examination of such areas later on.

At the end of the phase, the auditor is expected to have identified any problem areas which need further examination in detail.

Phase IV. In-depth Examination of Problem Areas, Data-gathering, Analysis, and Evaluation

In this phase, the auditor concentrates on audit findings on the problem areas in terms of:

a) compliance with or adherence to legal and policy mandate, prescriptions, and requirements;

b) goals and objectives-achievement;

c) operational efficiency, economy, and effectiveness in the use of human, material, and financial resources; and

d) propriety, accuracy, reliability, and usefulness of financial records and reports, including the effectiveness of control over the latter.

In-depth examination may involve reviewing agency reports, books, files, records, and such other relevant documents and analysing, evaluating, verifying and confirming their content through enquiries, inspection, or observation. Where it becomes impossible or impractical to examine all operations and transactions, the auditor conducts reviews and tests on a selective basis, based on his professional judgement and on the adequacy of internal control systems.[33]

The auditor develops the factual and documentary evidence to support his audit findings, conclusions, and recommendations. He analyzes the data gathered and determines the causes and effects of the problems, and their significance to agency operations. He also determines whether the agency needs to take corrective action and recommend the appropriate solutions. The auditor must alert agency officials on any deficiencies discovered during audit to enable management to take immediate corrective action.

In the financial aspect, the auditor formulates his findings, conclusions, and recommendations based on his evaluation of how well the agency's financial statements conform to the accounting standards against which they have been measured. He then gives his opinion (auditor's opinion) on the fairness with which the financial statements reflect the actual financial position of the agency and the results of its operations.

The results of this phase form the basis for the preparation of the draft audit report.

Phase V. Preparation and Presentation of Draft Report

A draft audit report is prepared based on the findings and recommendations formulated in the previous phase. The report is then presented to agency officials for their review and comments.

An "exit meeting" is held between the auditor (or audit team) and agency officials to discuss reactions to the findings, conclusions, and recommendations in the draft report. An open and frank discussion leads to agreement on the nature and factual basis of the problems and the measures needed to deal with them.

Phase VI. Finalization of Audit Report

After the meeting, the auditor finalizes the audit report. In writing the final report, he has to observe certain principles or standards of report writing. The scope of the audit should be stated clearly and concisely in the report and any limitations should be explicitly mentioned.

The report should be positive in its tone, as well as clear and complete in its findings and recommendations, in order to encourage the agency management to improve its operations.

It should also give a balanced perspective in that satisfactory aspects of operations and achievements are presented along with the deficiencies and problems. Previous efforts exerted by agency officials to correct deficiencies should also be noted.

Findings and conclusions should be adequately supported by factual documentary evidence. The recommendations should be clearly identified and should be realistic. Previous audit recommendations which have been unimplemented and the agency's reasons for such, should also be noted.

Phase VII. Follow-up On The Implementation Of Audit Recommendations.

Audit recommendations, such as suggested improvements, proposed adjustments in the accounts, correction or discontinuance of malpractices, solution to existing problems, etc. should be followed-up. There is always room for improvement in an agency's resources which consist of Manpower, material resources (consisting of money, supplies and materials, machineries representing its physical fixed assets-land; buildings and structures; furnitures, fixtures and equipment), and management methods and systems. It is such improvements that will lead to a full attainment of its objectives and goals, or in other words the realization of the 3 E's of agency management - economy, efficiency and effectiveness.

B. *General Objectives, Principles and Standards*

General Objectives

There are many objectives of state audit and all these relate to the concept of public accountability. Public accountability is central to government audit as it is anchored on the tenet that public officials, as stewards of public office, must give a full and public accounting of the manner with which

they utilize the powers and expend the resources entrusted to them. State auditing thus occupies a central role in its enforcement for it must verify, examine, evaluate, review, and attest to such stewardship.[34] As Caiden aptly put it: "whenever state audit has been downgraded, order, system, regularity, legality, frugality, and public trust have quickly declined."

Establishing accountability for financial, material and human resources of an agency is one objective of state audit.[35] There is the established tenet that a public official is a custodian or steward of all the resources of his office. Thus the head of agency exercises managerial responsibility over all personnel, funds, and properties of his agency. Further, as the law provides, every government official or employee whose duties allow or require the possession or custody of government funds and property is accountable and responsible for the fidelity in the custody or control over such resources (The Administrative Code of 1987). State audit seeks to establish the fiduciary and managerial accountability over public funds and properties of public officials. In other words, it aims to establish how and to what extent has the agency officials excercised their fiscal responsibility. State audit, through financial audit, does this by reviewing and attesting to the actual financial position of the agency, giving reports to higher authorities on the results of audit, and evaluating the soundness of agency control over its finances.

Establishing accountability for compliance with applicable laws, polices, rules and regulations is another objective of state audit. Accountability for compliance means the accountability of government officials to higher authorities for adherence to laws, policies, and rules and regulations.[36] Through financial and compliance audits, state audit aims to determine whether public officers have utilized their powers, authorities, and funds in accordance with legal, policy, and reglementary requirements and limitations.

The efficient, economical and effective operations of the agency is another accountability of public officials. Determining such accountability is also a state audit objective. As will be discussed in detail later, the COA is constitutionally mandated to recommend measures to improve the efficiency and effectiveness of agency operations. Thus, the state auditor performs performance audit, and on the basis of his findings, submits his recommendations to improve agency operations and performance in audit reports.

Specific Objectives

The specific objectives of state auditing also include the following, as enunciated in the Lima Declaration of Guidelines on Auditing Precepts[37]: (Annex I)

a. proper and effective use of public funds;

b. development of sound financial management;

c. orderly execution of administrative activities; and

d. communication of information to public authorities and the public through publication of audit reports.

Audit Principles and Standards

Government auditing by virtue of its critical and sensitive functions is necessarily bound by strict principles and standards of application.

Audit principles and standards serve to guide the auditor in conducting his audit with integrity, objectivity, independence, and efficiency.

Audit standards deal with the quality with which the audit is performed based on the professional and ethical qualifications of the auditor and his exercise of judgment in the course of audit. Professional audit standards also serve as guidelines to measure the quality of audit procedures used in the course of audit. Deviations from such standards result to unsatisfactory audit.[38]

On the other hand, audit procedures are the various methods used in obtaining evidence and the steps followed in accomplishing the audit. Audit techniques are ways and methods of gathering evidence and information; in a sense, a combination of procedures comprise an audit technique. Audit procedures and techniques form part of an audit program which is a program of action specifying the audit objectives, the scope or coverage, and the audit procedures and techniques to be used.[39]

IV. THE COMMISSION ON AUDIT

The Commission on Audit (COA) is the highest public institution legally responsible for conducting professional government audit in the country and as such is sometimes referred to as supreme audit institution (SAI).[40] In essence, the COA is official external auditor of the government.

Powers, Authority and Functions

The powers, authority and functions of the COA are as provided in Article IX-D of the Constitution:

1. Examine, audit, and settle all accounts pertaining to the revenue and receipts of, and expenditures or uses of funds and property, owned or held in trust, by or pertaining to, the government, or any of its subdivisions, agencies, or instrumentalities and such non-gov-

ernmental entities receiving subsidy or equity which are required to submit to COA audit;

2. Keep the general accounts of the government;

3. Preserve the vouchers and other supporting papers pertaining to such accounts;

4. Define the scope of its audit and examination and establish the techniques and methods required therefor, subject only to limitations imposed by Article IX-D;

5. Promulgate accounting and auditing rules and regulations, including those for the prevention and disallowance of irregular, unnecessary, excessive, extravagant, or unconscionable expenditures, or uses of government funds and properties;

6. Submit to the President and the Congress an annual report covering the financial condition and operation of the government and its subdivisions, agencies, and instrumentalities and non-governmental entities subject to its audit, and such other reports required by law;

7. Recommend measures necessary to improve efficiency and effectiveness in government;

8. Decide any case or matter brought before it within sixty days from date of its submission for decision or resolution; and

9. Perform such other functions as prescribed by law.

These functions may be categorized as:

1. **Auditorial**--includes audit and examination through pre- audit and post-audit services, and settlement of accounts or liabilities;

2. **Rule-Making**--exclusive authority to determine its scope of audit and examination and formulate accounting and auditing rules and regulations;

3. **Reportorial**--submission of reports to heads of audited agencies, the President, and Congress, and such other reports as required by law;

4. **Limited Accounting Function**--keeping the general accounts of government by accounting for transactions affecting the overall

cumulative results of operation (CRO)/current surplus of the national government;

5. **Custodial**--management and custody of the general accounts of government, custody of funds from tax refunds, and preservation of vouchers and other supporting papers pertaining to the general accounts;

6. **Quasi-Judicial**--decisionmaking on compromise claims, request for relief from accountability, and constructive distraint on property; initiation of criminal/malversation cases with Sandigandayan; issuance of opinions on queries;

7. **Recommendatory**--recommends measures to improve efficiency and effectiveness in general government and agency operations;

8. **Other Functions**--deputization of private licensed professionals to assist government auditors; participation in inventory of assets and properties; membership in policy study bodies.

To enable it to effectively carry out these various functions, the COA is organized as a constitutional commission, one of the very few audit bodies in the world so organized. As such, it may be considered, together with other constitutional bodies, as comprising the "fourth branch" of government.

Organization

The Chairman and two Commissioners collectively comprise the Commission Proper (CP) which is the highest policymaking body of the COA. The CP exercises its powers and authority collegially, not individually by any or all of the members of the CP. It has the authority, among other powers, to act on any appeal brought before it for final resolution. Its decision is appealable only to the Supreme Court on *certiorari*[41] The Chairman is both the presiding officer of the CP and the chief executive officer of the Commission.

As chief executive officer, the Chairman is the head of agency and assumes managerial accountability for agency operations and the performance of all agency personnel. His concern is "the greater tasks of management and administration of his agency".[42]

By legal definition, the Chairman and two Commissioners compose the Commission on Audit.[43] In practice however, the three do not participate in or personally audit disbursements and transactions involving government funds and property.[44] Actual audit, examination and settlement of accounts is performed by a resident auditing unit in each agency or office and headed

by an auditor whose duty is to exercise such audit powers over the accounts, funds, financial transactions and resources of the agency under his audit jurisdiction.[45]

Because the COA audits each and every government entity nationwide, it has a decentralized organization. It has a resident auditing unit in almost every agency or office. The unit is headed by a resident auditor who is assisted by assistant auditors, audit examiners, and audit aides. The COA resident auditor is possessed with full authority and powers needed by him to properly perform his duties. His decision is however appealable to the provincial/city or regional director.

Provincial and city auditors supervise the resident auditors in their respective areas. They are in turn supervised by regional offices in each of the country's administrative regions (including the Autonomous Region for Muslim Mindanao) which function as "mini Commissions." Headed by Directors, they supervise and control the implementation of auditing rules and regulations in agencies within the region; review, analyze and consolidate audit reports; and excercise authority on internal administrative, planning, financial, and legal matters within their respective areas of jurisdiction.

The COA central offices in Quezon City supervise and control the regional offices. The "operating offices"---Corporate Audit Offices I and II, Local Government Office, and National Government Audit Offices I and II, formulate standards and plans for the implementation of accounting and auditing rules and regulations in their respective sectors.

The Accountancy Office prepares the annual financial report of the national government and verifies appropriations of and controls funds released to national government agencies. The Special Audit Office (SAO) conducts special audits. The Technical Services Office develops auditing systems, renders consultancy services pertaining to auditing, accounting, and internal control systems, and reviews infrastructure contracts and projects. The support offices include the Legal Office; State Accounting and Audit Development Office; Planning, Financial and Management Office, and Administrative Office.

V. ISSUES AND PROBLEMS

A. The Proper Role of the COA

What is the proper role of the COA? In the Lima Declaration of Guidelines in Auditing Precepts, the role of the SAI is that of a "corrective power".[46] There is also the popular belief that the COA is a financial policeman, the guardian of public office, or the watchdog of the treasury whose function is to stop any and all misuse of public funds.[47]

Thus, there is the pervasive notion, even among COA auditors, that COA audit alone can effectively do the job. It is often the case that professionals (auditors, accountants, budget officers, etc.) strictly demarcate their mandates and responsibilities from each other and to preserve their professional turf engage in "professional rivalry" that only result to lack of coordination and cooperation. In a larger perspective, there is within government itself the phenomenon of "institutional jealousy" among the control and oversight bodies.

Some would claim that that this overarching role is impossible to realize and has become a major reason for the ineffectiveness of the COA.[48] It is argued that the auditor is only one of the guardians of the people's money; the others are the budget officer, the treasurer, the internal auditor, the accountant, the controller. The members of Congress, too, have an important role in preventing abuse of the public purse. But, at the forefront is the agency head himself who bears the primary responsibility for the proper use of the authority and the resources that go with it. It is a basic principle that "fiscal responsibility rests directly with the chief or head of the government division, agency or instrumentality. The role of the Commission on Audit is to determine whether such fiscal responsibility has been properly and effectively discharged".[49] The agency management has the prime duty to protect the financial interest of the government. The agency head is expected to exercise the "diligence of a good father of family" over the resources entrusted to his agency. The state auditor, for his part, should leave management alone to discharge such responsibility.[50] His concern is to establish systems of fiscal oversight and control and to see to it that these systems are working.[51] As aptly put: "The real lasting solution is to improve state financial management not by chasing down individual instances of fraud, waste, abuse and extravagance, but by adopting systems to prevent precisely fraud, waste, abuse and extravagance".[52] This role thus brings to fore the need for the COA auditor himself to appreciate such role in the total financial management system.

In addition, there is the common perception that the primary purpose of the auditor is fault-finding. This, according to some, also beclouds the proper role of the COA.[53] The COA's role is "to assist government achieve more efficient and economical operations, and formulate and implement programs tha will effectively attain the avowed social and economic development goals of the country".[54]

In a larger sense, the proper role of the COA as an institution should develop within the context of how auditing could effectively contribute to the cause of good government and national development. There is need for the COA to situate its role in the various concerns affecting not only fiscal management but also the larger issues of national development. A major concern which the COA should directly address is the foreign debt of the

country. There is also the influence of the World Bank- International Monetary Fund combine and the foreign creditors which effectively chart development finance, and thus, the development of the country.

The COA is part of the public administrative system for governance and development administration. It is recognized that within this system, its institutional development is strongly influenced by political and socio-economic factors; like any other public institution, it is constantly subject to the vagaries of national priorities and considerations that are beyond its control. At the same time, it is pressured to keep pace with a fast-paced world of technological improvements and sophistication in the functions and systems of government. In former colonies, audit institutionsare undegoing a painful process of detaching themselves from colonial structures in an effort at modernization. The situation is made more difficult where governments are usually beseiged by major societal problems, breakdown in government, and scarcity in resources.

State audit is constantly striving to remain relevant to the times. In the Philippines, its role has undergone a dramatic change in the last five decades. The challenge is for it to remain deeply rooted in the cause of what is best for the people.

B. The COA's Independence

One critical ingredient of COA's effectiveness is its institutional independence. The COA can only fulfill its mandate and functions if it is independent of the audited entity and is protected against undue outside influences. The COA was converted by the 1973 Constitution from the then General Auditing Office (GAO) into a constitutional commission. As such, it is treated as a body separate from the executive, legislative and judicial branches of government. Its status and independence is guaranteed by no less than the constitution. It is recognized, however, that its independence is not absolute. Being part of the State, it could not be independent of all public authorities (UN 1980:4).

The institutional independence of the COA is inseparably linked to the independence of its members. Presently, the leadership of the COA is a Commission Proper composed of a Chairman and two Commissioners. Such collegial composition is intended to minimize the opportunities to succumb to strong outside pressures. This was the intent behind the conversion of the one-man General Auditing Office (GAO) into a three-man Commission by the 1973 Constitution. In addition, it is envisioned that the powers and authority of the Commission Proper are to be exercised collegially, not individually by any or all of the members of the CP. This is based on the principle that power and authority granted to a collegial body must be exercised by that body as a collective act of all its members.[55] The COA

leadership is also protected from external pressures by the constitutional provision that the Chairman and the Commissioners cannot be removed from office except by impeachment.[56]

The COA likewise is imbued by the Constitution with the mandate and power to exercise institutional independence. The 1987 Constitution has seen fit to reiterate the state policy giving fiscal responsibility to agency management. Fiscal responsibility means that the COA does not have the power or authority to withdraw, disburse or use funds and property pertaining to other agencies or instrumentalities of government. Such power or authority belongs to the chief or head of office which is directly and primarily responsible for the funds and property pertaining ot his office or agency. What the Constitution mandates the COA is the authority to audit, examine and settle accounts of agencies and offices. Such interpretation has been upheld in jurisprudence.[57]

Another important ingredient to independence is fiscal autonomy. As with the other constitutional bodies, the COA is granted by the 1987 Constitution with fiscal autonomy. This includes the authority to augment any item in its budget from agency savings without need of presidential approval, the automatic release of its appropriations, and the like. However, its budget goes through the same process of budget review and approval by the executive and legislative offices as with the other agencies of government. This opens the COA to external pressures. In addition, its approved budget is subject to the vagaries of fund releases. As shown by studies, the actual releases are far less than the appropriated.

A legal framework can only provide the minimum condition for institutional independence. It is also important to recognize the political environment within which the COA operates. The COA, like any other government institution, is subject to the interplay of political actors in the political system. Even the strongest constitutional and legal guarantee of independence can not withstand the onslaught of decadent politics. On the other hand, a strong commitment and support from the political actors to the cause of effective auditing invariably encourages the audit institution to function with independence and effectiveness.

The professional, moral and ethical qualities of the COA auditor must also be considered. It is at the level of the individual auditor that the challenge of maintaining independence from the audited agency is more daunting. The auditor is constantly subjected to pressure as he is directly and actually engaged in audit work. More than that, he is engaged in a very sensitive function. He has to possess the technical and professional proficiency required of auditing. More importantly, he has to observe not only the moral and ethical standards of public service but also the strictures of his profession as an auditor.

A number of measures have been instituted to ensure the independence of the COA auditor. The assignment of an auditor to an agency is limited to three years to avoid fraternization with agency officials. Since 1987, the auditor has been barred from directly receiving any emoluments from the audited agency. In addition, continuous professional trainings are conducted. Significantly, the perception of the auditor on the integrity of his superiors and top leadership also bears on his own conduct.

C. The Case for Performance Auditing

Experiences in countries conducting performance audit point to the salutary effect of such audit on how plans are formulated, how programs are executed, and how available fiscal resources are budgeted and expended. Some of the benefits are:

a. clarity of aims and objectives of plans, programs, and projects, resulting to overall improvement in quality of planning;

b. clarity of agency responsibilities and authority to execute plans and programs;

c. quality and effectiveness of prgram implementation relative to plans;

d. quality of internal administration and reporting; and

e. quality of results in relation to predetermined objectives and costs.[58]

Performance auditing became a mandate of the COA in 1973 by virtue of a provision in the 1973 Constitution requiring it to recommend in its audit reports "measures necessary to improve their [agencies's] efficiency and effectiveness".[59] The same provision was adopted in the 1987 Constitution.[60]

The COA started performance auditing in mid-seventies with the creation of a Performance Audit Office. Performance audit was expanded and strengthened as part of comprehensive audit.

There are conceptual and practical constraints, as well as professional and attitudinal limitations to the full practice of performance auditing. Accountability for efficient, economical, and effective operations or program accountability as it is sometimes called is a relatively new field of auditing and is not usually incorporated in the financial systems of agencies. For example, present accounting systems do not use cost accounting so that performance audit which measures input-output relationships in terms of costs in its efficiency and economy tests can not be conducted. The lack of

timely, adequate, and comprehensive accounting data hinders the development of criteria.[61]

The same is true with the present budgeting system which uses line-item budgeting. Hence, most agencies have vague and generalized program objectives, plans, and targets. This poses a formidable constraint since a basic requirement of performance auditing is the clarity of the objectives and targets of plans and programs.

In addition, agency plans and programs have no clear standards by which results could be evaluated. This forced the COA to develop the standards by itself. In sum, performance audit requires quantifiable, reliable, and verifiable accounting information as a starting point for measurement and evaluation. Agency systems and procedures need to be rationalized accordingly.

There are also conceptual problems in measurement. In resource allocation for instance, the auditor can not conclusively determine whether the public welfare is improved by spending more for health or for education.[62] Further, the conduct of performance auditing requires an adequate financial audit to include in its evaluation the assessment on the profitability, capital budgets, and expenditures particularly in the case of public enterprises.[63]

Performance audit also requires special qualifications of the auditor. Performance audit necessitates multi-disciplinary academic preparation and experience in such general fields as public administration, business admninistration, economics, law, and the like, and specialized fields, such as policy administration, project management and evaluation, human resource development, local development planning, and so on. This is inevitable since performance audit on government covers the whole gamut of government operations in diverse sectoral concerns (agriculture, health, public safety, public works, science and technology). The professional preparedness of the government auditor inevitably becomes an issue.

Perhaps the greatest resistance to performance auditing is attitudinal. Faced with a relatively new field, both agency officials and auditors are skeptical and unconvinced of its benefits. To agency officials, performance auditing necessarily subjects their policy and operational decisions to scrutiny and judgment. Performance audit may also be an unwarranted encroachment on their management prerogatives and discretion over agency affairs. The auditor may also think that performance audit is only for developed countries, a perception disproved by the number of SAIs in developing countries carrying out performance audit successfully.[64]

On the part of the auditor, performance audit may represent a loss of power and prestige, not to mention privileges. The auditor may not easily

abandon financial and compliance audits which have long been the source of control over agency affairs. This is in addition to having to learn a new field which drastically departs from and even deemphasizes the fiscal audits to which they have grown accustomed.

D. Audit Reporting

The COA prepares some five different types of audit reports:

a) Annual Audit Report (AAR) on the audited agency or office prepared by the resident auditing unit;

b) Annual Financial Report (AFR) on the national government, which is prepared by the Accountancy Office, on the general accounts of the government including a summary of individual annual audit reports on national government agencies.

c) Annual Financial Report on local governments, which is prepared by the Local Government Audit Office, from the AARs of all local government;

d) Annual Financial Report on government-owned and/or controlled corporations (and their subsidiaries) prepared by the Corporate Audit Office, from individual AARs of GOCCs; and

e) Special Audit Reports prepared by the Special Audit Office.

Audit reports contain valuable information on how an agency expended its resources, accomplished its plans and targets, and what it could do to further improve its operations and performance. It recommends to policymakers and legislators measures to enhance the efficiency and effectiveness of national policies and programs. COA reports thus have great potential value as inputs for national development planning, fiscal policymaking, legislation, and implementation. At the agency level, they are indispensable to program planning, budgeting, and financial management.

Since 1975, the COA has exerted efforts to enhance the information value and timeliness of reports. Auditors have been trained to improve the reports' technical content and format. The preparation, review and approval process have been streamlined to ensure that reports are submitted on time to agency management and to Congress. Recommendations on efficiency and effectiveness have been included in reports. Since the mid- eighties, the COA started to take a more aggressive stance on national policies and priorities--foreign debt management, government corporate sector deficit,

and sale of government properties--to name a few. On these issues, the COA has made its voice felt and influenced the course of policies.

But what has really been the impact of audit reports on ageny operations? On national plans and policies? On legislation? On the people?

At the agency level, the annual audit report is a written product of the year-long audit process applied on the agency. It is finalized after a dialogue with agency officials. Aside from the information on the financial condition of the agency, the report contains recommendations to improve efficiency and effectiveness in agency operations. Auditors have long bewailed the unwillingness of agency officials to adopt some audit recommendations. Many recommendations are repeated every year in reports but remain unimplemented. Agencies, for their part, at times ignore adverse audit findings and the recommendations to correct deficiences. The inapplicability or unfeasiblity of some recommendations is sometimes given as an excuse. For lack of authority to impose sanctions for non-implementation, the auditor has no other recourse than to earnestly convince management that his recommendations are beneficial to the agency. The COA has no power of its own to enforce its audit recommendations. What it has is the authority to refer adverse findings to the Department of Justice or the Ombudsman for the filing of civil and/or criminal charges against the erring officials. Parenthetically, such authority is far from the ideal wherein the SAI can directly file charges with the courts.

While the COA religiously submits annual financial reports to the President, the positive influence of such reports on the formulation and implementation of national development plans and policies has yet to be clearly seen. Except in special audit reports which are submitted upon express directive or request of the executive branch, the annual financial reports have yet to be fully utilized in macro development and fiscal planning and evaluation. One may raise the issue of whether COA's audit directions and thrusts are in line with national development priorities and responsive to its information requirements. Further, the COA faces a dilemma: whether or not to review and pass judgment on national policy decisions and outcomes, and if so, to what extent? Other countries, notably Israel, has already gone into audit of policies.

The lack of an appropriate body or mechanism in Congress to ensure full utilization of audit reports in aid of legislation may also be raised. In other countries, particularly those with parliamentary systems of government, there is a Public Accounts Committee in parliament which uses audit reports in the review of agency accounts and budgets, and monitors the implementation of the auditor's recommendations by the agencies. It also reports to the legislature proposed policy measures based on audit report findings and recommendations.

There are also reasons why audit reports have little or no importance to the people. Reports are not easily accessible to the public; the ordinary citizen has to go through a bureaucratic process to get copies of annual audit reports. Usually, the reports are too technical for the layman. The challenge is for the COA to make reports public in simple and plain language.

E. Who will audit the auditor?

"Who will guard the guardians?" is a classic dilemma that the public is faced with, considering the tremendousness of the power and authority vested in the COA.

The COA itself is audited by a COA resident auditor, who is appointed by the COA Chairman. The audit of the COA by its resident auditor, however, does not require approval by the the Chairman. He is given under the State Audit Code with all the authority and powers needed by him to properly exercise his audit responsbilities. His relationship with the COA Chairman is just like the relationshuip of any other resident auditor with the head of the agency under his audit jurisdiction.[65]

In this way, the COA auditors are also audited and the COA Chairman and the Commissioners are made accountable to the people, as the Constitution requires.

ENDNOTES

[1]Israel State Comptroller's Office in Tantuico 1982:1.

[2]Gopez 1978:1.

[3]Gopez 1978:1.

[4]Caiden in Tantuico 1982:1.

[5]American Accounting Association Statement of Basic Auditing Concepts [1972].

[6]Tantuico 1988:49.

[7]Tantuico 1982:317.

[8]Glossary 1983:12.

[9]Tantuico 1982:316-317.

[10]Gopez 1978:3.

[11]Available "histories" of the state audit in the Philippines before political independence touch only the Spanish and American periods and tend to be silent on the short-lived First Philippine Republic.

See for example Arturo Besana, "Brief History or Auditing Practices and Procedures in the Philippines," COA Journal, Vol. 1, No. 4, May 1976, pp. 26-30, and Nazario Nadurata, "History of the General Auditing Offices," GAO Yearbook, 1955, p. 20.

[12]For accounts of fiscal administration during the First Philippine Republic, see Sulpicio Guevarra, The Laws of the First Philippine Republic, Manila National Historical Commission, 1972; Teodoro Agoncillo, Malolos, The Crisis of the Republic, Quezon City, University of the Philippines Press, 1960; and Short History of the Filipino People, Quezon City, Malaya Books, 1970.

[13]Besana, *op. cit.*

[14]Jose M. Aruego, The Framing of the Philippine Constitution, Volume II, 1937, pp. 573-574, cited in "State Audit Code and the Philippine Constitution," COA Journal, Vol. 21, June 1981, pp. 13-14.

[15]At the close of fiscal year 1982, backlog in post-audit of vouchers was reduced by 61%; for receipts, 30%. See Commission on Audit 1982 Annual Report, p. 5.

[16]Gopez 1978:15.

[17]Gopez 1978:15.

[18]Gopez 1978:19.

[19]Gopez 1978:19.

[20]Article IX-D, Section 2(1).

[21]Gopez 1978:22.

[22]Gopez 1978:22.

[23]Section 2(1), Article IX-D.

[24]Section 4, Article IX-D.

[25]Gopez 1978:22.

[26]Glossary 1983:270.

[27]UN 1977:35-36.

[28]UN 1977:36.

[29]Herbert 1982:15.

[30]Herbert 1982:15.

[31]Tantuico 1982:15.

[32]Tantuico 1982:16.

[33]Tantuico 1982:16.

[34]Tantuico 1982:20.

[35]Tantuico 1982:1.

[36]Gopez 1978:8.

[37]Gopez 1978:8.

[38]UN 1980:30.

[39]Gopez 1978:12.

[40]Gopez 1978:13.

[41]UN 1977:4.

[42]A writ issued to annul or modify the proceedings, as the law requires, of a tribunal, board, or officer exercising judicial functions, who has acted without or in excess of its or his jurisdiction, or with grave abuse of discretion, there being no appeal, nor any plain, speedy, and adequate remedy in the ordinary course of law--Tantuico :285.

[43]Reply, p.16.

[44]1987 Constitution Article IX-D, Section 1 (1).

[45]SC DEcision, p.21.

[46]SC Decision, p.20.

[47]UN 1980:4.

[48]Domingo 1992: .

[49]Tantuico 1988:27,37.

[50]PD 1445, Section 2.

[51]Tantuico 1988:27.

[52]Tantuico 1988:27.

[53]Tantuico 1988:33.

[54]Tantuico 1988:34.

[55]Tantuico 1988:34-35.

[56]Tantuico 1988: 27,37.

[57]Section 2, Article IX-D.

[58]SC Decision, p.20.

[59]UN 1977:36.

[60]Section 2(3), Article XII-D.

[61]Section 4, Article IX-D.

[62]UN 1980:63.

[63]Gopez 1978:9.

[64]UN 1980:12.

[65]UN 1980:13.

[66]Reply, pp. 10-11.I.

Annex I

THE LIMA DECLARATION OF GUIDELINES ON AUDITING PRECEPTS

PREAMBLE

The IXth Congress of INTOSAI, meeting in Lima:

- Whereas the orderly and efficient use of public funds constitutes one of the essential prerequisites for the proper handling of public finances and the effectiveness of the decisions of the competent authorities;

- whereas, to achieve this objective, it is indispensable that each country have a Supreme Audit Institution whose independence is guaranteed by law;

- whereas such Institutions become even more necessary in view of the fact that the state has expanded its activities into the social and economic sectors and thus operates beyond the limits of the traditional financial framework;

- whereas the specific objectives of auditing, namely, the proper and effective use of public funds; the development of sound financial management; the orderly execution of administrative activities; and the communication of information to public authorities and the public through the publication of objective reports, are necessary for the stability and the development of states in keeping with the goals of the United Nations;

- whereas at the previous international congresses of the Supreme Audit Institutions the Plenary Assemblies adopted resolutions the dissemination of which was approved by all member countries;

RESOLVES:

- To publish and disseminate the Paper entitled "The Lima Declaration of Guidelines on Auditing Precepts".

I. GENERAL

Section 1. Purpose of audit

The concept and establishment of audit is inherent in public financial administration as the management of public funds represents a trust. Audit is not an end in itself but an indispensable part of a control system whose aim it is to reveal deviations from accepted standards and violations of the principles of legality, efficiency, effectiveness and economy of resource management early enough so as to make it possible to take corrective measures in individual cases, to make accountable parties accept responsibility, to obtain compensation, or to take steps to prevent such violations from recurring or at least to make this more difficult.

Section 2. Pre-audit and post-audit

1. Pre-audit represents a before the fact type of review of administrative or financial acts; post-audit is audit after the fact.

2. Effective pre-audit is indispensable for the sound public financial administration of entrusted funds. It may be carried out by a Supreme Audit Institution or by other audit institutions.

3. Pre-audit by a Supreme Institution has the advantage of being able to prevent detriment before it occurs, but has the disadvantage of creating an excessive amount of work and of blurring responsibility under public law. Post-audit by a Supreme Audit Institution highlights responsibility of the accountable party, may lead to compensation for the damage caused, and may prevent violations from recurring.

4. It depends on the legal situation and the conditions and requirements of the respective country whether a Supreme Audit Institution carries out pre-audit. Post-audit is an indispensable task of any Supreme Audit Institution regardless of whether or not it also pre-audits.

Section 3. Internal and external audit

1. Internal audit services are established within individual agencies and institutions, whereas external audit services are not part of the organizational structure of the institutions to be audited. Supreme Audit Institutions are external audit services.

2. Internal audit services necessarily are subordinate to the head of the agency within which they have been established. Nevertheless they shall be as functionally and organizationally independent as is possible within the respective organizational structure.

3. In its capacity of an external audit service, the Supreme Audit Institution has the task of examining the effectiveness of the internal audit service. If the internal audit service is judged to be effective, efforts shall be made, without prejudice to the right of the Supreme Audit Institution to carry out an overall audit, to achieve the most appropriate division or assignment of tasks and cooperation between the Supreme Audit Institution and the internal audit service.

Section 4. Formal audit and performance audit

1. The traditional task of Supreme Audit Institutions is to audit the legality and regularity of financial management and of accounting.

2. In addition to this type of audit, the importance and significance of which is undisputed, there is another type of audit which is oriented towards performance, effectiveness, economy and efficiency of public administration. This audit includes not only specific aspects of management, but comprehensive management activities including organization and administrative systems.

3. The auditing objectives of Supreme Audit Institutions - legality, regularity, efficiency, effectiveness, and economy of financial management - basically are of equal importance; it is left to the Supreme Audit Institution to determine the relative prominence to be given to each.

II. INDEPENDENCE

Section 5. Independence of Supreme Audit Institutions

1. Supreme Audit Institutions can fulfill their tasks objectively and effectively only if they are independent of the audited entity and are protected against outside influence.

2. Although state institutions cannot be absolutely independent because they are part of the state as a whole, the Supreme Audit Institutions shall have the functional and organizational independence required to fulfill their tasks.

3. The establishment of Supreme Audit Institutions and the necessary degree of their independence shall be laid down in the Constitution; details may be set out in legislation. In particular, adequate legal protection by a supreme court shall be guaranteed against any interference with the independence and the auditing authority of the Supreme Audit Institutions.

Section 6. Independence of the members and officials of Supreme Audit Institutions

1. The independence of Supreme Audit Institutions is inseparably linked to the independence of its members. Members are defined as those persons who have to make the decisions for the Supreme Audit Institution and are answerable for these decisions to third parties, consequently the members of a decision-making collegiate body or the head of a monocratically organized Supreme Audit Institution.

2. The independence of the members, too, shall be guaranteed by the Constitution. In particular the recall procedures, also to be embodied in the Constitution, may not impair the independence of the members. The method of appointment and recall of members depends on the constitutional structure of the country in question.

3. With regard to their professional career, the auditors of Supreme Audit Institutions may not be exposed to influences by the audited entities and may not be dependent on such entities.

Section 7. Financial independence of Supreme Audit Institutions

1. Supreme Audit Institutions shall be provided with the financial means to enable them to fulfill their tasks.

2. If required, Supreme Audit Institutions shall be entitled to apply directly for the necessary financial means to the public body deciding on the national budget.

3. Supreme Audit Institutions shall be entitled to use within their own framework of responsibility the funds allotted to them under a separate budget head.

III. RELATIONSHIP TO PARLIAMENT, GOVERNMENT AND ADMINISTRATION

Section 8. Relationship to Parliament

The independence of Supreme Audit Institutions guaranteed by the Constitution and by law also entails their having a very high degree of initiative and autonomy, even when they act as an agent of Parliament and undertake audits on its instructions. The relationship between the Supreme Audit Institution and Parliament shall be laid down by the respective national Constitution in accordance with the conditions and requirements of the country concerned.

Section 9. Relationship to government and administration

The Supreme Audit Institution audits the activities of the government, its administrative authorities and any other subordinate institutions. This does not mean, however, that the government is subordinate to the Supreme Audit Institution. In particular, the government bears full and sole responsibility for its acts and omissions and cannot absolve itself by referring to audit operations and to expert opinions of the Supreme Audit Institution unless such expert opinions have been delivered as legally valid and enforceable judgments.

IV. POWERS OF SUPREME AUDIT INSTITUTIONS

Section 10. Powers of investigation

1. Supreme Audit Institutions shall have access to all records and documents relating to financial management and shall be empowered to request orally or in writing from the audited entity any information they deem necessary.

2. The Supreme Audit Institution shall decide whether it is more expedient to carry out individual audits at the seat of the institution to be audited or at the seat of the Supreme Audit Institution.

3. Time limits for furnishing information or submitting documents and other records including final accounts to the Supreme Audit Institution, shall be set in individual cases either by law or by the Supreme Audit Institution.

Section 11. Enforcement of findings of Supreme Audit Institutions

1. The audited entities shall comment on the findings of the Supreme Audit Institution within a period of time generally established by law or specifically by the Supreme Audit Institution, and shall indicate the measures taken as a result of the audit findings.

2. To the extent the findings of the Supreme Audit Institution are not delivered in the form of legally valid and enforceable judgments, the Supreme Audit Institution shall be empowered to approach the authority which is competent to take the necessary measures and require the accountable party to accept responsibility.

Section 12. Expert opinions and other powers of collaboration

1. In important cases, Supreme Audit Institutions may place at the disposal of Parliament and the administration their professional knowledge in the form of expert opinions including comments on proposed laws and other regulations relative to financial matters. The administrative authorities shall bear the sole responsibility for accepting or rejecting such expert opinions; moreover, this additional task may not anticipate future findings of the Supreme Audit Institution and may not interfere with the effectiveness of its auditing action.

2. On the other hand, regulations for appropriate and as uniform as possible accounting procedures shall be passed only after agreement with the Supreme Audit Institution.

V. AUDITING METHODS, AUDITING STAFF, INTERNATIONAL EXCHANGE OF KNOWLEDGE

Section 13. Auditing methods and procedures

1. Supreme Audit Institutions shall audit in accordance with a self-determined programme. The rights of certain public bodies to request a certain audit in specific cases shall remain unaffected.

2. Since an audit can seldom be all-inclusive, Supreme Audit Institutions as a rule will find it necessary to use a sampling approach. The samples, however, shall be selected on the basis of a given

model, and they shall be sufficiently numerous to make it possible to judge the quality and regularity of management.

3. The auditing methods shall always be adapted to the progress of the sciences and techniques relating to management.

4. It is appropriate to prepare internal auditing manuals as an aid for the auditors.

Section 14. Auditing staff

1. The members and the auditing staff of Supreme Audit Institutions shall have the qualifications and moral integrity required to carry out their tasks completely.

2. In recruiting staff for Supreme Audit Institutions, appropriate recognition shall be given to above-average knowledge and capabilities and adequate professional experience.

3. Maximum attention shall be paid to furthering theoretical and practical professional development of all members and auditing staff of Supreme Audit Institutions, both in-house and at the university and international levels, and such development shall be encouraged by all possible means of a financial and organizational nature. Further development shall go beyond the traditional legal-economic and accounting knowledge and shall include other business management techniques such as electronic data processing.

4. To ensure auditing staff of excellent quality, salaries shall be commensurate with the special requirements of such employment.

5. If the auditing staff of a particular Supreme Audit Institution cannot handle specific cases because of the special professional knowledge involved, experts from outside shall be called in.

Section 15. International exchange of knowledge

1. The international exchange of ideas and experience within the International Organization of Supreme Audit Institutions is an effective means of helping Supreme Audit Institutions to fulfill their tasks.

2. This purpose has so far been served by congresses, training seminars jointly organized by the United Nations and other institutions, by regional working groups and by the publication of a professional journal.

3. It is desirable to expand and intensify these efforts and activities. Of prime importance is the development of uniform terminology in public financial audit, on the basis of comparative law.

VI. REPORTING

Section 16. Reporting to Parliament and to the public

1. The Supreme Audit Institution shall be empowered and required by the Constitution to report annually and independently to Parliament or other competent public body on its findings; this report shall be published. This will ensure extensive information and discussion, and create a more favorable climate for enforcing the findings of the Supreme Audit Institution.

2. The Supreme Audit Institution shall also be empowered to report between annual reports on particularly important and significant findings.

3. The annual report shall cover all activities of the Supreme Audit Institution; only in the case of interests worthy of protection or protected by law shall the Supreme Audit Institution carefully weigh such interests against the benefits of disclosure.

Section 17. Method of reporting

1. The reports shall present the facts and their assessment in an objective, clear manner and be limited to essentials. The wording of the reports shall be precise and generally understandable.

2. The point of view of the audited entities and institutions concerning the findings of the Supreme Audit Institution shall be given due consideration.

VII. AUDITING POWERS OF SUPREME AUDIT INSTITUTIONS

Section 18. Constitutional basis of auditing powers; audit of public financial management

1. The basic auditing powers of Supreme Audit Institutions shall be embodied in the Constitution; details may be laid down by legislation.

2. The concrete terms of the auditing powers of Supreme Audit Institutions shall depend on the conditions and requirements of the respective countries.

3. All public financial management, irrespective of whether and in what manner it is reflected in the general national budget, shall be subject to audit by Supreme Audit Institutions. Excluding pats of public financial management from the national budget shall not result in these parts being exempted from audit by the Supreme Audit Institution.

4. By means of their audits, Supreme Audit Institutions should strive for a clearly articulated budget classification and as simple and precise accounting system as possible.

Section 19. Audit of public authorities and other institutions abroad

As a general principle, public authorities and other institutions established abroad shall also be audited by the Supreme Audit Institution. Audits at the seat of these institutions shall give due consideration to the constraints laid down by international law; in factually justified cases, however, these limitations shall be reduced through the dynamic development of international law.

Section 20. Tax audits

1. Supreme Audit Institutions shall be empowered to audit the collection of taxes to the maximum possible extent and, in doing so, to examine individual tax files.

2. Tax audits are primarily audits for legality and regularity; however, when auditing the application of tax laws, Supreme Audit Institutions shall also examine the efficiency and organization of tax collection and the achievement of revenue targets and, if appropriate, shall propose improvements to the legislative body.

Section 21. Public contracts and public works

1. The considerable funds expended by public authorities on contracts and public works justify a particularly exhaustive audit on the funds used.

2. Public invitation for tenders is the most suitable procedure for obtaining the most favorable offer in terms of price and quality. Whenever public tenders are not invited, the Supreme Audit Institution shall find out why.

3. When auditing public works, the Supreme Audit Institution shall encourage the establishment of suitable standards for the continuing administration of such works.
4. Audits of public works shall be concerned not only with the regularity of payments, but also with the efficiency of construction management and the quality of construction work.

Section 22. Audit of electronic data processing facilities

The extent of the funds expended on electronic data processing facilities also calls for appropriate auditing. Such audits shall be systems-based and shall pay particular attention to planning for requirements; economical use of data processing equipment; use of staff with appropriate expertise, preferably from within the administration of the audited entity; prevention of misuse; and the usefulness of the information produced.

Section 23. Industrial and commercial enterprises with public participation

1. The expansion of the economic activities of governments frequently takes the form of enterprises that are established under private law. These enterprises shall also be subject to audit by the Supreme Audit Institution if the government has a substantial participation in

them - particularly where this is majority participation - or exercise a dominating influence.

2. It is appropriate for such an audit to be carried out as a post- audit; it shall also include economy, efficiency and effectiveness considerations.

3. Reports on such enterprises to Parliament and to the public shall observe restrictions required for the protection of industrial and trade secrets.

Section 24. Audit of subsidized institutions

1. Supreme Audit Institutions shall be empowered to audit the use of subsidies granted from public funds.

2. Should the purpose of the audit require it - especially in cases where the amount of the subsidy, either by itself or in relation to the revenues or the capital situation of the subsidized institution, is particularly high -, the audit can be extended to include the entire financial management of the subsidized institution.

3. Misuse of subsidies shall lead to a requirement for repayment.

Section 25. Audit of international and supranational organization

1. International and supranational organizations, whose expenditures are covered by member country contributions, shall require an external, independent audit similar to that of individual countries.

2. Although this audit shall be adapted to the structure and tasks of the respective organization, it shall be conceived along lines similar to those of the supreme audits of member countries.

3. To ensure the independence of such an audit, the members of the external audit institution shall be appointed mainly from within the Supreme Audit Institutions.

PART VII

GOVERNMENT-OWNED AND CONTROLLED CORPORATIONS

CHAPTER 19

GOVERNMENT-OWNED AND CONTROLLED CORPORATIONS

I. INTRODUCTION

II. THE PHILIPPINE GOCCs: DEFINED

III. THE LEGAL FRAMEWORK

IV. THE LAST DAYS OF THE MARCOS RULE TO THE PRESENT

V. GROWTH OF GOCCs

VI. FINANCIAL STATUS AND PERFORMANCE

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IX. TOWARDS RATIONALIZATION OF GOCCS AND PRIVATIZATION: THE PHILIPPINE CASE

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GOVERNMENT-OWNED AND CONTROLLED CORPORATIONS

I. INTRODUCTION

The widespread activities of public corporations owned and operated by the government are related with the problems of public administration in developing countries. A rapid growth in the number and size of these enterprises has been observed in developing countries for the last few decades. Once present only in traditional activities such as in utilities (electricity, gas and water), and transportation and communications (buses, airlines and railroads, and postal services), public enterprises "have become active in such key sectors as large-scale manufacturing, construction, finance, services, natural resources, and agriculture."[1] In fact, in some developing countries, these corporations contribute more than 60% of the value-added in manufacturing and natural resources.[2]

In the Philippines, its average gross value added in manufacturing for the period 1975 to 1984, is relatively low at about 1% while in financing, which had been mostly a private sector activity in the past, a high 33%.[3]

As of 1985, there are more public enterprises in the manufacturing sector (19% of total) than in any other sector. In agriculture, forestry and fishery, there are 20 of these corporations (or 8%).[4]

Just how important government corporations have become can be gathered from the statements of Todaro (1989):

> *"Overall, it is clear that state-owned enterprises (SOEs) are playing a major role in the economies of developing nations, contributing an average of 7% to 15% of their GDPs. In some cases, their contribution is considerably higher; for example, they produce 20% to 30% of the domestic output in Senegal, Guinea, Tunisia, and Venezuela and almost 40% of the output in Ghana and Zambia. In addition, SOEs account for a substantial amount of investment in developing countries, yielding at least a quarter of the total capital formation and, in a few cases, considerably more."*

The growing importance of state-owned enterprises in the economies of developing countries make it necessary to have a grasp of the reasons for their creation:[5]

1. Monopoly power
2. Capital formation
3. Private incentive
4. Control in strategic sectors
5. Others

1. To ensure that prices are not set above output costs, direct government control in many Third World countries may be required. Some goods that have high social benefits are usually provided at a price below their costs or even free (these are often referred to as "public goods" as mentioned in earlier chapters), thus, the private sector has no incentive to produce such goods, and the government must take care of their provision.

2. Capital formation is especially strong at the early phases of development when private savings are very low. At this point, investment in infrastructure is vital for laying the groundwork for further investment. Moreover, GOCCs often remain important at later stages in those industries that require massive funds.

3. The lack of private incentive to engage in promising economic activities because of: (a) uncertainty about the size of local markets; (b) unreliable sources of supply; and (c) the absence of technology and skilled labor is another motivation for creating public enterprises. Governments of developing countries would certainly like to expand employment and facilitate training of the labor force through engaging in public production, and to increase export earnings by creating export industries. Moreover, these governments may seek to locate enterprises in backward sectors to achieve income distribution.

4. The desire of governments to gain national control over "strategic sectors" of the economy such as defense, or over "foreign-owned enterprises" (MNCs) whose interests may not coincide with those of the country, or over key sectors for planning purposes.

5. Other reasons include: (a) bankruptcy of major private industries which necessitate government take-over; and (b) ideological motivations, among others.

I. THE PHILIPPINE GOCCS: DEFINED

In the Philippines, a government-owned or controlled corporation GOCC) is defined as "a stock or a non-stock corporation, whether perform-

ing governmental or proprietary functions, which is directly chartered by special law or, if organized under the general corporation law, is owned or controlled by the government directly or indirectly through a parent corporation or subsidiary corporation, to the extent of at least a majority of its outstanding capital stock or of its outstanding voting capital stock."[6]

A legal definition is provided in Administrative Order No. 59 which defines a GOCC, as:

> *"A government-owned and/or controlled corporation ... is a corporation which is created by special law or organized under the Corporation Code in which the Government, directly or indirectly has ownership of the majority of the capital or has voting control; Provided that an acquired asset corporation as defined...shall not be considered as a GOCC or government corporation."*

Among the common characteristics of a GOCC are the following: (a) at least 50% of it is owned by public authorities (central, state or local); (b) it is under the top managerial control of the owning public authorities; (c) it is established for the achievement of a defined set of public purposes; (d) and is consequently placed under a system of public accountability; (e) it involves the basic idea of investment and returns; (f) it engages in activities of a business character; and (g) it markets output in the form of goods and services.[7]

III. THE LEGAL FRAMEWORK

The 1986 Constitution lays down the overall framework for GOCC policy in Article XII, Sections 16-19. These provisions reflect efforts to limit the unwarranted proliferation of GOCCs and ensure economic viability. These provisions likewise reflect recognition of the abuses in the use of the GOCCs which accounted for their substantial contribution to the crisis of the 80's.

Thus, Section 16 provides that only Congress may create GOCCs "in the interest of the common good and subject to the test of economic viability." The latter is reflected clearly in P.D. 2029.

Section 17 emphasizes that the State may take over privately owned public utilities or businesses affected with public interest only during national emergencies and on a temporary basis.

Section 18 cites national welfare or defense as bases for establishing and operating vital industries, and for transferring to public ownership utilities and other private enterprises.

Section 19 provides for regulation or prohibition of monopolies when public interest so requires.

Another provision in the Constitution seeks to regulate foreign borrowings of GOCCs. Section 20 of Article VII provides that the Monetary Board shall submit quarterly reports to Congress on its decisions for application for loans "to be contracted or guaranteed by the government or government-owned or controlled corporations.

While the Constitution regulates and seeks to limit the use of the government corporate form, it emphasizes at the same time the leading role of the private sector in the economy. Thus, Article II, Section 20 recognizes the "indispensable role of the private sector, encourages private enterprise, and provides incentives to needed investments."

Presidential Issuances

Insofar as presidential issuances are concerned, Administrative Order No. 59 defines the policy thrusts under the Aquino administration. The major policy concerns of P.D. 2029, insofar as limiting the creation of GOCCs, providing for monitoring and supervision and according them differential treatment are reflected in A.O. 59.

On the other hand, Proclamation No. 50 and 50-A on privatization reflect the basic concerns of P.D. 2030.

All other policy pronouncements of the present administration flow from these two issuances.

Supervision and Monitoring of GOCCs

What are the agencies which supervise and monitor GOCCs? The agencies which have traditionally performed this function continue to do so. These are the Department of Budget and Management for purposes of the budget, the National Economic and Development Authority, the Department of Finance and the Office of the President. The Commission on Audit continues to perform its constitutionally mandated audit functions.

The traditional functions of DBM have been expanded by the fact that the functions of the Presidential Committee Government Reorganization (PCGR) have been transferred to it.

The concept of "ministry supervision" or "department attachment" is still practiced. Thus, GOCCs are assigned to specific departments or agencies whose functions are allied to their own functions.

An innovation which was started under the Marcos administration, the GCMCC, is carried on at present under much expanded functions and jurisdiction. As reconstituted under Executive Order No. 236, the GCMCC serves as the central inter- departmental body for monitoring GOCCs. Originally lodged in the Department of Finance whose Secretary serves as Chairman, the GCMCC is now directly under the Office of the President.

Continuing Interest of Multilaterals and Bilaterals

Current GOCC policy is frequently articulated in loan agreements with bilaterals and documents submitted for the consideration of the international aid community. Thus, privatization was given special mention in the documents for the Philippine Assistance Program. Even more telling is the fact that in the Letters of Intent submitted to the International Monetary Fund, including the Supplemental Memorandum privatization was submitted as the centerpiece of government corporate reform. Obviously, the multilaterals and bilaterals require repeated assurances of, and commitment to accelerated privatization of the government corporate sector.

IV. THE LAST DAYS OF THE MARCOS RULE TO THE PRESENT [8]

Presidential Decrees Nos. 2029 and 2030 were among the last decrees signed by then President Marcos prior to his ouster. P.D. 2029 defines what a GOCC is and sets the conditions under which GOCCs may be created. P.D. 2030 promulgates the privatization policy. These policy decrees were later restated in subsequent presidential issuances under the present administration.

The environment under which this policy framework was formulated includes a host of social, economic and political conditions that present problems to the policymakers which subsequently complicate their efforts.[9]

The international environment includes the global push towards reduction of the size of the public corporate sectors in many countries and the adoption of privatization as a policy solution to the problems plaguing this sector. Specific institutions pushing for public corporate sector reduction include the multilaterals like the World Bank, the International Monetary Fund

and the Asian Development Bank. Bilateral institutions include the USAID. Subsequently, assistance and aid programs to developing countries were premised on reduction of the corporate sector and accelerated privatization. Policies on public enterprises at this time drew inspiration from the experience of Great Britain in privatizing its mammoth public enterprise sector.

The general mood in the international setting during the decade of the eighties was a return to traditional free market economics with primacy given to the role of the private sector.

Domestic events which served as a backdrop for GOCC policy include the external debt crisis which triggered off a crisis for the entire economy. It was recognized that the public corporate sector accounted for more than three fourths of the external debt burden at that time.

At the height of the crisis, the need for structural loans strengthened external pressure to privatize. This policy thrust was supported by local policymakers faced with the task of putting order to the disarray in the public corporate sector.

During the change in administration, the international push for public sector reduction and privatization was still irresistible, especially in the light of the need for additional loans.

It appears that GOCC policy during the last days of the Marcos administration as well as those pursued at present were shaped and formulated primarily by the multilaterals and the policymakers. The participation of GOCCs was primarily indirect -- through documents and information which they provided, informal channels with the policymakers and through the departments to which supervised them.

Consultations were limited to professionals whose views and opinions were sought on policy issues and who were commissioned to conduct studies and analyses. Final decisions were made by the policymakers in constant consultation with the multilaterals, particularly the World Bank.

Under the present administration, Administrative Order No. 59 and Proclamation No. 50 were formulated with the active participation of two major interest groups: the employees of the GOCCs and the clients and recipients of GOCC services were not involved. This is not surprising because the GOCC policies of both administrations were formulated at periods when power was centralized in the executive -- a dictatorship under Marcos, and a revolutionary government under Aquino.

V. GROWTH OF GOCCs

The growth of the GOCC sector has been well documented by several studies.[10] From a total of 40 (30 parent corporations & 10 subsidiaries) in 1960, the number tripled in 1975 with the subsidiaries growing more rapidly than the parent corporations. In 1981, the number of subsidiaries grew by as much as 12 times than they were in 1960. When the Aquino government took over in 1986, the GOCCs already totaled to 327. Of the total number, 105 are parent corporations, 144 are subsidiaries, 18 subsidiaries of subsidiaries, and 60 are acquired assets.

The identified public enterprises were classified by the Commission on Audit as follows:[11]

	1986	1987[a] (Audited)
Financial Corps.	27	25
Infrastructure & Public Utility Corps.	27	20
Industrial & Integrated Area Development Corps.	102	68
Agricultural, Trading & Promotional Corps.	66	59
Social, Educational, Scientific, Cultural, Civic & Research Corps.	45	30
Acquired Assets	60	-
TOTAL	327	202

[a] Excluding acquired assets.

This unequaled growth in the number of public sector enterprises (PSEs) resulted to the public sector's playing a major role in activities once dominated by the private sector such as petroleum refining and trading, sugar trading, land transportation, hotel operation, rubber and coffee plantation, and others.[12] Duplication of functions of some government corporations became inevitable.[13]

VI. FINANCIAL STATUS AND PERFORMANCE

In 1987, the 164 audited GOCCs and acquired asset corporations had assets valued at P782 billion and liabilities of P623 billion. These GOCCs had a combined net worth of P160 billion and total income before subsidy of P107 billion.[14]

For the same year, total financial assistance by the National Government to GOCCs totaled P36 billion, of which only P9 billion consisting of equity contributions, subsidies and loans outlays was obligated and formed part of total expenditures of the National Government. The balance of P26 billion or 74.3% of total assistance represents advances to GOCCs for debt-servicing of guaranteed and relent loans. The P36 billion assistance to GOCCs constituted about 18% of National Government expenditure of P194 billion.[15]

For the past decade from 1978-1987, aggregate National Government fund to GOCCs reached P179 billion, increasing at a yearly average of 22%, representing a 21% share in the annual average expenditure of the National Government.[16]

In the last decade, gross value added (GVA) in the sector lagged behind that of the total economy. The share in gross domestic product (GDP) is also low compared to that in other countries.[17]

Gross value added of public enterprises peaked in 1983 accounting for about 3 percent of GDP. However, for the rest of the period between 1975 and 1984, it averaged to only 2.0 percent of GDP.[18]

Performance indicators such as factor productivity and financial profitability ratios showed unfavorable signs. The prevailing perception that public enterprises are less efficient than their private sector counterpart seems justified. In addition, total factor productivity of the whole economy was more than 5 times that of government corporations in 1976 to 1980 and about 9 times in 1981 and 1982.[19]

During the Aquino administration, however, the budgetary burden of government corporations is said to have been put under control.[20] This is evidenced by the declining national government subsidy, equity and net lending contributions to these corporations, i.e., from an average of about 3 percent of GNP in 1981 to 1985 to 2.2 percent average in 1986 to 1990.

The table below shows the total NG budgetary contributions to GOCCs, and as percent of GNP & total government expenditures:[21]

	Subsidy	Equity	Net Capital Lending	Transfers to PNB/ DBP	TOTAL (in million pesos)	NG CONTRIBUTION TO GOCCs (% of GNP)	(% of NG Expenditures)
1976	280	1,846	100	0	2,226	1.66	10.89
1977	1,030	2,274	45	0	3,299	2.15	14.46
1978	663	4,438	(21)	0	3,080	1.74	11.84
1979	479	3,398	853	0	4,730	2.17	15.87
1980	622	4,522	675	0	5,819	2.44	15.61
1981	523	8,081	929	0	9,533	3.49	20.39
1982	1,979	9,368	2,218	0	13,565	4.41	25.78
1983	1,104	5,739	2,394	0	9,237	2.59	17.41
1984	430	9,845	4,423	0	14,698	2.93	21.96
1985	1,009	14,353	1,679	0	17,041	3.11	21.27
1986	1,720	12,336	15,148	4,409	33,613	5.72	30.60
1987	1,835	4,414	7,077	0	13,326	2.02	11.11
1988	2,032	1,823	5,415	0	9,270	1.13	6.81
1989	5,575	2,107	4,082	0	11,764	1.22	6.84
1990	8,687	4,434	(791)	0	12,330	1.09	5.68
Total	27,968	86,928	44,226	4,409	163,531	2.31	13.74

The ratio of savings to investments (the self-financing ratio) of the major nonfinancial GOCCs averaged 100 percent for 1986-1987 compared to a low 13 percent average for some 60 GOCCs in 1975-1984.[22]

These developments are said to be due to both improvements in the economic performance of the GOCCs during the period and the reduction of the planned investments of these corporations, e.g., the ratio of actual to planned GOCC investment is .52 in 1987 and .65 and 1988. Meanwhile, the ratio of actual receipts to actual current expenditures is 1.16 and 1.25 compared to the planned ratios of 1.13 and 1.07 in 1987 and 1988, respectively.[23]

VII. ISSUES AND PROBLEMS

Anomalous practices reflect the government's inability to cope with the unprecedented growth of the government corporate sector. First, there is the issue of some government corporations regulating their competitors in the private sector. Second, some government nonfinancial corporations behave like financial corporations. Third, other GOCCs collect taxes like regular government bureaus.[24]

Furthermore, there is the matter of overlapping directorates which became rampant as government Ministers (now Secretaries) assumed multiple directorship in various GOCCs. A specific example is the observation of the Commission on Audit (COA) that one Minister (now Secretary) was in the Board of Directors of 43 government corporations while another was in 40 in 1984.

A more important issue is the poor financial performance accompanied by high levels of capital expenditures. This resulted to the GOCCs requiring a disproportionately large portion of the national government's budgetary resources (of about 29 per cent). In addition, a substantial portion (of more than 50 percent) of the external debt of the consolidated public sector is accounted for by the GOCCs. [25]

VIII. ON THE ISSUE OF POOR PERFORMANCE

Although GOCCs contribute to domestic output and capital formation, they are also absorbing large amounts of resources. In several cases, they are imposing heavy fiscal burden on governments. To illustrate this, Todaro (1989) cited the following:

> *"A study of 27 developing countries in 1976-1979 revealed that the net budgetary payments to nonfinancial SOEs averaged more than 3% of GDP. Current spending alone represented 1.4% of GDP. And SOEs were found to be major borrowers of foreign exchange, accounting for 28% of all Third World Eurocurrency borrowing in 1980. They also absorb a large part of domestic credit, particularly in small countries; in Benin, Guinea, Mali, and Senegal, for example, over 40% of domestic credit was absorbed by SOEs."*

In recent years, GOCCs are often criticized for wasting of resources and making demands on scarce government funds, as well as on domestic and foreign credit. In many cases, these are only reflective of the low profitability and inefficiency in the sector.

Data from the World Bank for state-owned enterprises in 24 developing countries in 1977, as cited by Todaro (1989), revealed only a small operating surplus. However, when interest payments, subsidized input prices, and taxes and accumulated arrears were taken into account, GOCCs in many of these countries showed a large deficit.[26] Operating on a deficit, these corporations often times proved to be a massive drain on government resources. As in most developing countries, this is true for the Philippines. Among the major contributors to the fiscal burden for the period 1974 to 1984 are:[27]

Corporation	Amount (Million Pesos)
National Power Corporation	15,804
Development Bank of the Phils.	13,758
National Irrigation Administration	4,157
National Development Company	6,693
National Electrification Administration	2,004
National Housing Authority	2,019
Philippine National Oil Company	2,508
Philippine National Bank	1,998
Metropolitan Waterworks & Sewerage System	1,470
Human Settlement Development Corporation	1,147

In 1986, losses of two government financial institutions, PNB and DBP, were recorded at P7.4 billion.[28] Since these corporations are unable to service their debts (which were mostly guaranteed by the national government), the national government, in effect, had to assume these debts to avoid default and possible negative consequences.[29]

A summary of the financial operations of monitored non- financial GOCCs from 1986 to 1990 is shown below:[30]

	1986	1987	1988	1989	1990	TOTAL
I. Total Receipts	38,738	49,837	59,818	57,521	76,468	282,382
II. Current Expenditures	38,425	43,091	47,848	45,549	68270	243,182
III. Capital Expenditures	5,881	7,863	9,026	14,967	27,261	64,998
IV. Capital Transfers	1,211	(1,362)	0	0	0	(151)
V. Internal Cash Generation	313	6,746	11,971	11,972	8,198	39,200
VI. Financial Deficit (-)/Surplus	(6,779)	245	2,944	(2,995)	(19,063)	(25,648)
VII. Net External Financing	(5,261)	319	(2,875)	2,603	6,299	1,084
VIII. Net Domestic Financing	12,040	(564)	(69)	392	12,764	24,563

From 1986 to 1990, total receipts was P282 billion pesos, while current expenditures was P243 billion in addition to capital expenditures of P65 billion. Capital transferred totaled to negative P151 million. This resulted to a financing deficit of P25.6 billion for the same period.

Overall poor performance of GOCCs in terms of profitability and efficiency could be attributed to (a) the fact that they are expected to pursue both commercial and social goals, i.e., providing goods at prices below costs in an effort to subsidize the public, or hiring extra workers to meet national employment objectives; (b) the overcentralization of their decision making, which allows little flexibility; (c) the "bureaucratization" of management -- many decision makers are not accountable for their performance and little incentives is provided for improved decision making; and (d) despite the abundant labor supply and the employment mandate, access to capital at subsidized interest rates has often encouraged unnecessary capital intensiveness.[31]

IX. TOWARDS RATIONALIZATION OF GOCCS AND PRIVATIZATION: THE PHILIPPINE CASE

Introduction

The above problems which plagued many public corporations in developing countries are not beyond solution.[32] The alternatives include (1) reorganization with greater "bottom line" focus for the GOCC; and (2) transfer of ownership and control from the public to the private sector -- also known as "privatization".[33]

In the first alternative, points to decentralization of decision making to allow for more flexibility and providing better incentives for managers to increase efficiency. Also, providing capital at its market rate may eliminate the bias toward capital intensiveness.[34] Todaro cited the Chinese Government example:

> *"The Chinese government took important steps in this direction when it gave greater autonomy to and increased competition among its million urban SOEs in late 1984. In short, public corporations can still play an important role in economic development as long as the "political will" is there to minimize abuse of power and the "economic will" is there to correct socially unnecessary price and market distortions."*

The second alternative -- "the privatization of state-owned enterprises in both the production and financial sectors -- hinges on the neoclassical

hypothesis that private ownership brings greater efficiency and more rapid growth. During the 1980s, privatization has been actively promoted by major international bilateral (USAID) and multilateral agencies (the World Bank and the IMF). Many developing countries have been following this advice, although the extent of their philosophical agreement as opposed to the financial pressures exerted by these funding agencies remains unclear. In addition to the belief that privatization improves efficiency, increases output, and lowers costs, proponents argue that it curbs the growth of government expenditure, raises cash to reduce public internal and external debt, and promotes individual initiative while rewarding entrepreneurship. Finally, supporters of privatization see it as a way to broaden the base of ownership and participation in the economy, thereby encouraging individuals to feel like they have a direct stake in the system."[35]

However, there are many issues involved. Among these are the "questions of feasibility, appropriate financing, the structure of legal and property rights, the role of competing elites and interest groups (e.g., public officials and bureaucrats versus domestic and foreign private business interests), and whether or not widespread privatization promotes or ultimately weakens existing dualistic economic, social, and political structures."[36]

To claim that privatization will automatically lead to higher profits, greater output, or even lower costs is misleading. As Todaro aptly stated: "The key issue is whether such privatization better serves the long-run development interests of a nation by promoting a more sustainable and equitable pattern of economic and social progress. Despite all of the ideological trumpeting by "free-marketers,' on this issue the evidence so far is less than persuasive."

The case of the Philippines

Letter of Instructions 1454 issued in April 1985 directed the Special Presidential Reorganization Committee (SPRC) to conduct studies aimed at rationalizing the government corporate sector. Among the recommendations of the Committee are: (a) the limiting of the use of the government corporate form to certain areas/activities; (b) the institutionalization of effective supervision; (c) the coordination and control of government corporations hand in hand with the provision of adequate operational flexibility to the said enterprises; and (d) the abolition, merger, retention or privatization of specific corporations. However, these were overtaken by the change in administration in February 1986.[37]

In the 1987-1992 Medium Term Development Plan there was a call for a program that will:[38] "(1) limit the use of the government corporate form to those activities that are usually considered to be natural monopolies, those that require large and physically indivisible capital investments, those that are characterized by long and uncertain gestation periods, and/or those that

are deemed essential from the point of view of national welfare, security or defense; (2) dispose of existing government corporations that do not meet the criteria outlined in (1) above; (3) established an integrated system of performance evaluation for the remaining government corporations; and (4) improve the system of supervision and control of government corporations." These policy statements were consistent with that of the former government pronouncements.

At the end of 1986, Proclamation 50 creating the Committee on Privatization (COP) and the Asset Privatization Trust (APT) as the implementing arm of the COP was issued. A comprehensive policymaking function relating to the rehabilitation, conservation, take-over and the disposition of government corporations and acquired assets of government financial institutions is vested to COP which is headed by the Secretary of Finance and is composed of the Secretaries of Budget and Management, Trade and Industry, Justice, and Economic Planning.

Briones and Zosa[39] summarize the conditions that led to the formulation of the policy:

> *"In 1983, two years before the collapse of the Marcos regime, the debt bomb exploded and the Philippine government at last declared its inability to pay its gargantuan $28 billion foreign debt and solve the balance of payments crisis. In the ensuing shambles, Finance Minister Cesar Virata admitted that public enterprises accounted for 80% of the foreign public debt. Negotiations for a restructuring of the public enterprise sector were initiated with the World Bank. Conditionalities specified a policy declaration defining government-owned or controlled corporations (the Philippine term for public enterprises) and, explicitly limiting the participation of public enterprises in the economy. A twin policy of privatization was likewise required.*
>
> *Two presidential decrees on public enterprises were among those last signed by the former President when the February revolution toppled down the Marcos regime and ushered in Corazon C. Aquino. Those decrees were Presidential Decrees 2029 and 2030, which defined and restricted the definition of GOCCs and declared a policy of privatization. President Aquino later adopted these very same policies as major thrusts of her administration".*

The restructuring of the public enterprise sector was financed by the World Bank economic recovery loan for $300 million, thus giving it the formal and acknowledged lead role in every step of the process. The Presidential Commission on Reorganization((PCR)), as the lead agency at the Philippine

end conducted an inventory and drafted the study under the watchful eye of the World Bank which provided detailed terms of reference. The Commission on Audit had serious objections on the issue of granting "differential treatment" to GOCCs; it insisted that at least 50% ownership of the enterprise be the criterion for calling it a GOCC but in the final version of P.D. 2029, this item was not carried. COA likewise registered its objection to differential treatment of GOCCs on the issue of accountability. In every step of the way, the heavy hand of World Bank intervention was visible.

The policy on privatization was in a sense "inherited" but fully adopted by the Aquino administration. During its initial negotiations with the Aquino government in 1986, the World Bank (WB) pressed for an appropriate policy structure, and the improvement of the monitoring and operations of the GOCCs.

Privatization, in the context of the current administration, is the major program for the disposition of certain GOCCs and their assets. The program's objectives are four-fold :

1. To reduce involvement of the state in the nation's economic activities;

2. To reduce the financial burdens on the government due to losing and inefficient GOCCs and their assets;

3. To promote greater efficiency in government operations;

4. To raise funds from the sale of GOCCs and their assets.

The privatization program in the Philippines is actually a case of "re-privatization". As pointed out by Macapagal: "Many assets have originally belonged to the private sector or should properly belong to it. There is the phenomenon of former owners buying back their companies".

This policy was premised on the following:

1. The proliferation of GOCCs over the past two decades resulted to government domination of the economy. Other studies show that the alleged domination was held, not by GOCCs but by the transnational corporations.

2. The public sector has invaded the private sector's domain of investments. It is quite known that this was the other way around. Due to manipulations in the previous administration, even viable GOCCs had fallen into the hands of high-profile moguls from the

private sector. A more detailed inspection as to who were sitting on the GOCC directorates at that time would have revealed that they were controlled directly or indirectly by private sector managers or Presidential cronies, associates and relatives.

3. Privatizing certain GOCCs will result in significant financial gains and reduction of losses for the government. Aside from the obvious need of the Aquino government for cash to finance its projects, it is envisioned that selling off these GOCCs will ease the financial burden of government that pays interests on loans granted to them. These expected gains from the disposition have been proven to be losing propositions, with government losing up to about 30% of the assessed value of the assets . In part this is due to multiple problems encountered in the implementation of the disposition mode. Examples are equipment that have deteriorated or have lost their market value, irrelevance of the GOCC's product, etc. Other causes may be traced to market factors and procedural problems.

There were reports[40] that some P7 billion was lost over an 18-month period in the sale of 82 non-performing assets starting in January 87. A DOF study (cited in the Teodosio study) claims that the government can lose as much as P70 billion and under the most favorable valuation scheme, this can be reduced to P4 billion. It is estimated that about 108 corporations with aggregate assets of P153 billion and combined net worth of P15 billion are targeted for privatization over a five-year period. Aside from these corporations, a preliminary listing shows about 365 non-performing assets or idle accounts in government financial institutions with loan exposure of P165 billion. The government is hoping to earn P100 billion from the first round of sales of the first 100 corporations.[41]

4. Privatization will result in greater efficiency in operations that will redound to better provision of services than is currently available from the GOCC. This claim can be validated only after a certain period of time has elapsed. However, from the common experience of dealing with private monopolies as PLDT or MERALCO, the quality of service that may be expected needs to be ensured through control measures if this is possible once the firm has been privatized.

In the process of evaluating the GOCCs, the Committee on Privatization(COP) had to look for alternatives to outright sale. Disposition or divestment has not been limited to plain getting rid of assets through sale. It included:

a) abolition
b) merger or consolidation
c) "regularization" or reverting the GOCC to department-unit form
d) conversion to private status

The Disposition Schedule

The COP has targeted the following Implementation Plan over the five-year period of its existence :

	1989	1990	1991	1992	TOTAL
No. of GOCCs for					
Privatization	29	31	68	-	128
Non-Privatization	62	11	2	15	90
TOTAL	91	42	70	15	218

By the last quarter of 1989, the total number of GOCCs to be moved was determined to be 128 corporations as recommended by the COP. This infers speeding up of disposition activities by APT, DBM and the authorized parent corporations within the period of five years.

Four other government corporations are authorized to conduct privatization activities as parent corporations: [42] Philippine National Bank, for its subsidiaries; GSIS for its "quality accounts" such as PAL, Philippine Plaza Hotel, Manila Hotel); National Development Company, for its subsidiaries; and the Department of Agriculture, over FTI, the sugar refinery and the cotton ginneries. This authority does not overlap nor is in conflict with the dispositive powers of APT since they all have to secure clearance with the COP. The power of the parent corporation to chart the course of their subsidiaries has been limited to the day-to-day operations; investment plans are subject to APT scrutiny and approval.

Difficulty in moving all 128 corporations due to resource and time constraints is foreseen. In the event that the resources of interested local buyers do not improve, these investors will prefer to put their money in the "quality accounts" rather than in other GOCCs with lesser turn-around potentials. Revenue target for 1989 from the sale of GOCCs was expected to finance the Comprehensive Agrarian Reform Program.[43]

Problems and Issues in Implementation

Marketing Problems

Who are the buyers of non-performing assets and non-viable GOCCs? Due to economic interests and resource constraints (on the part of other interested business sectors), the most likely buyer-groups are the former owners; some foreign investors; and industry competitors. For instance, negotiations for the repurchase of the Nonoc Mining and Industrial Corporation, the country's major producer of nickel, is the latest and most pressing endeavor of the Philippine Mining and Industrial Corporation (Philnico), led by Jesus Cabarrus and his group, former owners of Nonoc. Philnico has signed a memorandum of agreement for the purchase and is talking to foreign groups for loans to settle accounts with other creditors as a precondition to the sale[44]. Should Philnico's bid fail, at least three other foreign buyers, including the Bond Corporation of Australia have expressed their interest in Nonoc Mining. Another example is, in the sale-through-bidding for Midland Cement Corporation, Hi- Cement Corporation and Philippine Carrier Management.[45]

What terms and conditions would be most favorable to the government? Local companies of former owners are not given preemptive rights over other bidders by APT and DBM but should they eventually recover their former holdings, purchase agreements must contain terms most favorable to government (e.g. financial stability or at least, settling all obligations with its creditors by the bidding company). However, in the case of industry competitors (as in the cement industry) who have a natural interest in Midland Cement, the possibility of forming a cement cartel is not farfetched.

Entry of Foreign Investors

Even at the highest levels, the current administration has consistently invited the entry of foreign investors into local industry. This move has caused some concern among nationalist circles. For vital industries such as the nickel corporation or the paper industry, disposition must include full protection of the national economy, preferably against significant foreign control[46]. The corporate financial profile of local bidders must be examined to prevent foreign domination of company shares.

Shortage of Buyers

There is definitely a shortage of buyers of assets. Two public auctions held in October this year attracted no bidders for the country's biggest paper company, Paper Industries of the Philippine (PICOP), and a condominium building. A medium size commercial bank (Associated) and a cotton ginneries company had only one bidder each. A more recent auction for the

Maricalum Mining Company was also a failure, in spite of expectations that two local and one foreign bidder would come in. Under COA rules, a one-bid auction is declared a failure.

APT Associate Trustee Felipe Bince[47] thinks that bidders have ulterior motives in staying away from the bidding. He alleged that these companies were out to pressure APT into negotiated sale, a disposition method that runs counter to the policy of transparency in the bidding process. The APT is now expected to request exemption from the COA rules that will enable APT to at least open the one bid and consider the offered price. Such consideration is not however final as it its the COP that will decide whether or not the bid is acceptable within 30 days.

Investment adviser Edgardo del Fonso (also former Finance Undersecretary) is allegedly quoted as saying: "It's all a matter of pricing and the conditions of the assets they're trying to sell".[48] Del Fonso also recommended that "one way to attract foreign investors is to relax equity rules and allow foreign companies to own 100% of a project." Under existing rules, foreign capital is limited only to 40% of total equity for ventures engaged in natural resource exploitation.

The Need for Industrialization

Many GOCCs up for sale are vital to the nation's economy since they were the natural foddering grounds of the business elite under the past regime. The privatization program has in effect, pitted the nation's need to industrialize against the obvious marketability of these GOCCs engaged in vital or heavy industry (e.g. National Steel Corporation, PICOP, Nonoc Mining, the cement firms, oil corporations). The question may be asked: is the objective of cash generation more important than the retention by government of these vital industries? Are there alternatives other than outright sale that can maximize the use of these assets?

In the case of the National Steel Corporation, the industry association of steel users have filed a petition with the Senate Committee on Industry condemning the efficiencies of the NASCO management.[49] Inquirer columnist Henares is now pushing for the pending Senate Bill authored by Senator Sotero Laurel that will rush privatization of the steel mill and rehabilitate the steel industry, with new equipment and incentives that have not been possible under the present management.

Procedural Problems

Other guidelines issued by the COP in the sales procedures have been revised to give APT more leeway. Previously, APT was allowed to dispose of assets worth P60 million and below without COP approval. This authority

ceiling has been raised to P300 million in order to hasten the awarding of bids. APT has announced that of the total 399 assets to be disposed of (worth more than P10 billion) there are less than 20 assets whose individual value is more than the new ceiling[50]. With broader powers, APT is in a better position to meet its target privatization proceeds of P25 billion by 1991.

Among the agencies and GOCCs involved in the privatization program, there are certain areas of disagreements over policies and procedures. Even as COP exercises its approving authority over the sale of assets, at least two other "parent" GOCCs of subsidiaries continue to be involved in the investment activities of their subsidiaries. There was a proposal from GSIS to dispose of Meat Packing Corporation partially to the private sector by retaining 60% of the shares. This was disapproved by the COP because of the standard practice of retaining only up to 30% of the total shares or totally sell out the asset.[51] The COP has made it clear that as insurance companies, GSIS and SSS should take only a passive and not an active role in the investment activities for their subsidiaries. The COP affirmation of existing rules on the matter hold true for other future dispositive plans that may be recommended by PNB and NDC over their respective subsidiaries.

The APT has its share of total squabbles also with former owners of assets and their creditors. Restraining orders or injunctions against more than 20 assets to be privatized (e.g. Bayview Prince Hotel, Davao Timber Corporation, Marsteel Corporation, Floro Textiles, Golden Country Farms, etc.) filed against APT has been recently lifted by a Supreme Court decision [52]. The APT has no immunity from court injunctions as provided under Proclamation No. 50. Under the new ruling, such injunctions can no longer hamper the APT from exercising its mandate.

Former owners are also out to protect their interests. They object to outright sale as well as to non-privatization modes being considered (such as merger with another company, hiring of a management group to take charge over the asset, or listing of the bank's shares in the stock exchanges). At the same time, creditors of former owners of these assets usually request that sale proceeds be held in escrow until resolution of their claim is cleared. The appraised value of these assets with claims from former owner total about P2 billion while the transfer price paid to DBP and PNB by the national government approximates P3.7 billion.[53]

Legal technicalities have also cropped up. A few months back, the APT had to file a joint motion with the PCGG at the Sandiganbayan seeking authority for the PCGG to lift sequestration orders on the same assets. These assets had already been transferred from PCGG jurisdiction by the government financial institutions to APT but could not be sold because of the sequestration orders. The Sandiganbayan had ruled that properties still

under litigation or whose "ill-gotten" character had not been resolved could not be transferred. The motion was upheld in the Supreme Court decision.

APT's image as a superbody in asset disposition does not exempt the agency from COA rules and regulations. Aside from being subject to COA bidding procedures; APT transactions are still subject to COA review. A COA report[54] on the 1988 transactions of the APT include irregularities on the uses of funds generated from the sale of assets. APT Chief Executive Trustee Ramon Garcia is confident that there was nothing wrong with the transactions, having done things "for the best interest of the national government". At this point, it may be mentioned that credibility of the APT has been hinged primarily on the reputation and perceived personal integrity of its Trustees as Presidential appointees. APT's existing "honeymoon" with the general public has so far been preserved with their policy of transparency in all transactions. However, this condition has not lulled COA into complacency; no less than a COA Associate Commissioner has oversight responsibility over the APT.

APT also faces a Congressional probe into the sale of PICOP[55]. Under House Resolution No. 1497 in October this year, Manila Congressman Ramon Bagatsing and Renato Yap allegedly stated that the government lost some P7.5 million in the sale of PICOP shares, there having been a failure in bidding for the paper company. For this sale and other future sales, APT Chief Executive Trustee Ramon Garcia welcomes congressional inquiry so APT can explain the privatization scheme.

Apparently, COP and APT watchers tend to examine the assets' sale at face value. This was an observation of DBM Director Josefino Angeles[56] who is active in the non-privatization project of DBM. More often than not, critics look at the more obvious costs (e.g. national government exposure in a certain asset, how much was assumed from the government financial institution) and compare it against what the asset is estimated to be worth in the open market, with little thought for operations and maintenance costs and the obvious depreciation and/or deterioration of physical assets if the government were holding on to the asset.

Labor Problem

A major irritant to the implementation of the privatization program is the lack of safeguards for the rights of the labor sector. Basically, this need has been overlooked by the architects of Proclamation 50 and 50-A. Several provisions negatively affect the labor aspect: Section 25 (4) authorizes personnel retrenchment while Section 27 and 31 denies the employee the vested right to future employment if a GOCC is retained, and without court redress. Amendments to the fiat have been sought in a labor conference on

Privatization manifesto [57] in August 1988 but so far no formal changes have been issued.

[58] Former Labor Secretary Franklin Drilon batted for bigger issues as well. From a long-term prospective, he is hoping that the Privatization program can achieve one its basic justification - to democratize the ownership of the means of production and thereby affect a redistribution of wealth. Aside from assuring that the economy will be controlled by Filipinos, he sees the emergence of a strong middle class as investors; the protection of the welfare of the lower income worker; and (the workers) participation in the ownership of the disposed corporation. Drilon cited an application of an employees' union for the arrastre and stevedoring operations of the Cebu port as an example. Giving lower-income union employees of the appropriate financing will be a step forward for mass-based ownership of the means of production.

External Pressures

As mentioned earlier, international financing institutions like the World Bank and the IMF have tied up the release of succeeding tranches to conformity with the conditionalities set in the loan packages. With respect to the GOCCs, public sector borrowing requirements have placed the government financing institutions in a bind and have often given in to WB-IMF pressure.

Very recently, the WB warned against the tendency of the Aquino Administration to continue with subsidies to certain sectors such as the oil subsidy and the wage standardization programs. Both programs having serious economic and political implications, government ignored the warning on the wage standardization subsidy and has pursued it. However, in the fuel subsidy, government has bowed to such pressure. Fuel and oil prices has increased almost overnight by about 30% to the liter, putting additional burdens to the average consumer in this overburdened economy.

The WB is also set on "recommending" the merger of the GSIS and the SSS, to integrate the two pension funds for the public and private sector employees.[59] The IMF, on the other hand wants Government to unload 51% of its shares to the private sector through the stock market. The PNB had previously unloaded 30% of its equity shares in June this year.

Such meddling in the economy does not extend to the details of privatization program, some top officials say. Budget Secretary Caraguе[60] states: "WB-IMF participation in the creation of the policy does not bother me so long as its is good for the country. They don't really determine the nitty-gritty; it is we who determine whom to sell the asset to. We should not view their role here (in the program) as a constraint but rather as a tool."

Macapagal[61] provided some insights into what he calls the WB- IMF's common approach to clients in developing countries and industrialized countries: "They use a common approach for both and in the process, they are somehow insensitive to the idea that the developing countries are less well-fed with different needs and require new approach." He thinks the WB-IMF does not determine "where it will hurt" in giving the medicine for economic ills, it is Government's decision where it will hurt. However, Macapagal wishes that these institutions' expose their field directors to the problems of developing countries first hand for a better understanding of the problem.

Accomplishments

In 1991, 123 GOCCs were approved for privatization. Of these, 82 have been offered for sale since program inception in 1987 while only 69 were actually sold. This is far below the original projection of disposing 100 GOCCs which represent 80% of total book value (of P78 billion). Gross revenues from privatization is given below: [62]

	1987	1988	1989	1990	1991*	TOTAL
1. Privatization of GOCCs	1,200	3,150	1,900	290	2,460	9,800
2. Transferred Assets	6,780	5,160	4,030	15,390	1,640	33,000
2.1 APT/GFI Sales	3,830	3,700	2,030	14,500	1,640	25,700
2.2 GFI Collections	2,940	970	690	0	0	4,600
2.3 Other Income	10	490	1,310	890	0	2,700
TOTAL	7,980	8,310	5,930	15,680	4,100	42,000

*As of end September 1991.

Total revenues from privatization from September 1987 to 1991 from all sources is P42 billion with income from transferred assets accounting for 79% & from privatization of GOCCs, 21%.[63]

As of September 30, 1991, approximately P15.0 billion generated from the sale of transferred assets had been remitted to the Bureau of Treasury for the Comprehensive Agrarian Reform Program. This amount received may be broken down on an annual basis as follows :[64]

1987	P 1.039 B
1988	P 5.399 B
1989	P 3.666 B
1990	P 3.600 B
1991*	P 1.332 B
TOTAL	P15.036 B

*As of September 1991.

Comparative Country Experiences in Asia the APDC Seminar

This part of this policy paper draws heavily from the papers presented at the Policy Level Seminar on "Privatization of Public Enterprises" organized by the Asian and Pacific Development Center (APDC) and the UP-College of Public Administration on October 23-25, 1989 in Manila. The APDC is a Malaysia-based institution that seeks to respond to Asian needs through a network of research institutions in the Asia-Pacific rim area. Recently, APDC carried out a study of eight countries (i.e. Australia, China, India,Korea, Malaysia, Philippines, Sri-Lanka and Thailand) on their respective privatization experiences. Country reports with a regional overview are the main source documents. The study uses the international term "public enterprises" (PEs).

Privatization has swept the Asian countries involved in the study in the early 80s. New economic adjustment measures had to be adopted in the wake of impending economic growth for the Third World. These countries share common experiences such as political changes, financial upheavals and for most of them, the glut of international credit facilities to finance national growth in the 1960-70s. Conditions prior to privatization witnessed the active expansion of government activities in the public enterprise sector. At the conceptual stage of the study, it was no longer necessary to ask if privatization was necessary, but in what manner it was to be undertaken. Social objectives such as equity and the democratization of public enterprise ownership, economic growth and its concomitant costs and benefits are also taken into account.

What were the reasons for privatization? The APDC study groups the reasons into four: financial (caused by general shortage of funds of the national government and of the public enterprise itself); the economic inefficiency of the PEs; external factors such as foreign investors, international lending institutions (WB, IMF, etc.) and economic management; and the non-economic reasons such as ideology and equity.

The Instruments of Privatization

The study divides the instruments for Privatization into two categories: from macro-privatization and from micro- privatization. Macro-privatization instruments are sale of assets and liberalization. Sale of assets is meant to reduce the number of PEs on a short-term scale; liberalization refers to deregulation and decontrol of economies on the long term. Liberalization includes the modality of "marketization" - the use of market prices and the introduction of market competition; divestiture or transfer of ownership from public to private sector is also another modality of liberalization.

Australia, Malaysia, Philippines, Sri Lanka and Thailand are moving towards these modalities. Researchers refer to Malaysia, Philippines and Sri Lanka as the "rapidly privatizing economies" because they possess a sense of urgency in implementation. They share five common pressures: fiscal crunch, BOP deficit; efficiency; low industrial growth rate; and IMF pressures for structural adjustment. China and India are more cautious, going for liberalization, because of internal pressures that required reforms.

Highlights of the Country Experiences

- In Australia, direct sale of state-owned assets belonging to public agencies were sold to raise revenues for the Exchequer. Municipal and local government functions have been contracted out to private parties, resulting in greater cost savings and more efficient municipal services.

- China has attempted to deregulate state controls on PEs. Joint stock companies and contracting out management of PEs with emphasis on reforms are in practice. This is supported by newly- introduced bankruptcy laws. Professional managers have taken over, other innovations include linking of wages with profits and open market sales of products and services. Public accountability runs high.

- Divestment has taken place on a modest pace in India. The private sector have new opportunities to participate in national development, specifically in the gas and oil sector. Capital markets have been enhanced through the years. A strong political will is under lobby which can lead to more effective planning and preparation for privatization.

- Malaysia has the strong political will to undertake a systematic privatization scheme of over 800 active PEs. Progress has been slow but steady; it is the only country that has a master plan. Significantly, the Malaysian program protects the interest of the Bumiputra or the indigenous community and labor.

- Korea is implementing a 5-year program selling off eleven huge enterprises with a total value of $8 billion. Its unique feature is the equitable distribution of equity shares to lower income groups.

- Sri Lanka puts great emphasis on equity. Contracting out of the management of textile mill PEs are successful but the management experience in the road transport sector is below expectations. In the short run, the exchequer has been relieved of its resource crunch.

- Thailand has fewer PEs and a strong market economy. It is therefore targeting improved performance. A strong labor sector has resisted divestments, thus forcing government to look at other measures such as leasing, franchising, contracting out and setting up of joint ventures.

General Conclusions

First, privatization has now acquired a new range of modalities, giving more room for experimentation.

Second, an understanding of the pressures that lead to privatization has been gained. The analysis shows that internal pressures of inefficiency and low industrial growth rate are the catalysts to external pressures. Liberalization or reorientation of public sector's role have therefore become relevant.

Third, privatization through sale of PEs will not solve the internal inefficiencies. The modalities of privatization have to be widened to provide the private sector encouragement, development of capital markets and restructuring of PEs.

The APDC Study Recommendations

1. There is a need for the clear understanding of why an economy has to privatize. Having achieved an understanding of the internal pressures, what is the primary pressure that should be resolved on the short-term? On the long term?

What modalities should be employed in privatizing the PEs? These will depend on the analysis of the capital market internal to a country. The choices among measures to employ or combinations thereof are available to policy makers who know their economy best. Liberalization, divestiture, and corporatization are the alternative measures that are open to policy makers.

2. The Value of Planning for Privatization

The country case studies have shown that rushing into the program without studying the various modalities available have resulted into in marginal gains. Positive effects would be wiped out by the disadvantages. There is also the prevailing institutional framework to consider. The case studies further postulates the five conditions of success as requisites to privatization plans and these are:

- clarity of objectives
- choice of appropriate measures
- development of market structures
- careful with built-in safety clauses
- monitoring impact.

Details are important. There are no shortcuts. A systematic approach is necessary. Reforms at the macro and micro levels are part of the approach. If necessary, performance appraisal must be required by evaluators of the privatization program of the PEs.

3. There is a need to develop an appreciation of the tension resulting from privatization. Safety clauses for labor must be built into the plans. The other source of tension is the entry of transnational corporations into the country's vital industries against which national interests must be guarded.

Comparative Country Experiences in Asia - The IILS Seminar

The comparative country experiences discussed during the APDC seminar were concerned with regional trends and situational contexts of the policy in each country. Another seminar on the "Social and Economic Consequences of Privatization in Asia" was held almost simultaneously under the auspices of the International Institute of Labor Studies, the Association of Development Research and Training Institutes of Asia and the Pacific (ADIPA), and the UP College of Public Administration.

The seminar included researchers from Korea, Malaysia, Thailand, India, Indonesia and Bangladesh whose papers focused more on the social consideration of the policy.

In his keynote address, (then) Secretary of Labor Franklin Drilon[65] batted for the social aspects of the Privatization program in the Philippines. More importantly, Drilon focused on the neglect of labor rights in the privatization process. Proclamation 50 does not contain provisions for workers' protection : there is no consultation with workers of firms being privatized; neither is there a provision which directs the buyers to absorb existing personnel. What is even worse, Section 27 provides for automatic

termination of employer-employee relations upon privatization; it also confers upon the new management the discretion to absorb or not to absorb the employees which, he bewails, "renders nugatory, by mere accident of change in ownership, their right to security of tenure as enshrined in the Constitution."

The potential disruption of industrial peace that Drilon touched upon was the subject of a study organized by the UP School of Industrial Relations with assistance from the International Labor Organization (ILO)'s ASEAN Program of Industrial Relations and Labor Studies. The study recommends that:

1. Labor should be represented in the APT and other agencies tasked with disposing firms/assets for privatization.

2. The Department of Labor and Employment (DOLE) be given a role in the Privatization process particularly in the mediation/ arbitration of labor disputes.

3. Section 27 of Proclamation 50 be removed and Section 31 be amended to provide a venue for those affected where they can seek legal remedies.

4. The whole Privatization process be made transparent to all parties particularly to affected employees.

The Philippine labor sector has been actively airing its sentiments with respect to the privatization program in two labor conferences. The first one was held in August 1988 in Quezon City sponsored by the UP School of Labor and Industrial Relations in coordination with the Friedrich Ebert Stiftung. The Conference participants assessed the program and its impact on labor and drew up policy recommendations for government, trade unions and employees to consider. The manifesto included a program of action and strategies for the labor movements.

In November 1988, a Conference/Workshop on "Privatization and its Impact on Labor Relations in the Philippines" was held among various labor groups in Villa Escudero, Tiaong, Quezon. A more detailed summary of similar sentiments and demands have been included in the manifesto cited above.

The full protection of labor rights is not beyond achievement in the Philippine experience. It was a major consideration in the negotiated sale to the private sector of the Maria Cristina Fertilizer Plant in Northern Mindanao in 1960.[58] The winning bidder, Marcelo Tire and Rubber Corporation, was awarded the sale of the plant through a Cabinet decision over the offer

of Marinduque Iron Mines. Although Marcelo was outbidded by his opponent in peso terms, the Cabinet spokesman announced that Marcelo's willingness to guarantee retention of all plant employees and laborers was a deciding factor. The contract also included a provision that would allow the workers to invest up to 12.5% of the capital stock of the new corporation to be organized. This opportunity however, was not availed of by the workers who felt that investing their hard-earned savings in the losing firm was a big risk. As a sign of further goodwill, the Marcelo management gave out the equivalent of three shares of stock to each plant worker as Christmas bonus. If current policy implementors can approximate Marcelo's concern for labor in these times, the potential irritant to the program can be diffused.

Other Asian countries have shown the same characteristics. Edgar[66] cited three case studies in his paper: that of Japan National Railways(JNR), the manufacturing enterprises in Bangladesh and the Port Klang Container Terminal in Malaysia. He categorizes the experience of J N R as positive in the sense that its privatization achieved the objectives of reducing losses, reducing labor costs and increasing efficiency of services. To a certain extent, the management of JNR was able to secure industrial peace by breaking the back of the most militant labor union, with full government support. Government took the initiative of absorbing 30,000 displaced laborers into other public companies over a period of 6 years; the other 31,000 were given retraining or self-employment opportunities in the private sector. Government's sincere effort in helping out in this case has left only about 4,000 more to be deployed.

In the case of Bangladesh, resistance to privatization has increased with its experience in the textile industry. While layoffs were restricted during the first year of the new company's operations, workers were terminated with benefits as soon as the prescribed period was over. Moreover, the increase in the casual workforce contributed to labor's insecurity.

Malaysia's privatization experience in the Port Klang Container Terminal has given its policymakers some thinking to do for the future. In spite of the great care taken by government in soliciting the support of the unions, and the options given to the labor force, there is insufficient data to prove that services and productivity at the Terminal did increase with privatization. The country's privatization program is spread out over a ten-year period, but still there exists an inherent tension between the dual objectives of unleashing the resources and energies of the public sector and protecting the interest of the Bumiputra [67], thus pulling the policy implementors in two directions. Salleh concludes that questions of increased efficiency in the provision of services remain unanswered, and on a wider scale, the social welfare gains. What is more obvious is the increase in government revenue due to sale of shares. He perceives privatization to have little impact on the reduction of public employment. Democratizing ownership of the Terminal has given the

union workers adequate shares in the new corporation; they have anchored their continued support for the Terminal on additional shares to be made available to the labor sector. The Malaysian experience has turned out to be expensive along these lines but it is so far one of the most successful privatization programs in terms of social and economic considerations for labor.

A total of 301 GOCCs have been listed and reviewed for dispositive actions under the program. Of these number, 127 are to be privatized, while 174 are to be subjected to Non- Privatization.

Of the total 127 for privatization, four GOCCs had already been privatized prior to DBM involvement in the program. The DBM teams have reviewed and recommended 123 firms for privatization to the COP, all of which now have Presidential approval.

Of the proposed for regularization, 17 have the Presidential approval.

Meanwhile, 78 GOCCs are to be retained as corporate bodies.

A total of 18 GOCCs have been approved for consolidation or merger; another 58 have been approved by the President for abolition.

As of end of September 1991, the disposition of 299 have been approved by the President as recommended by the COP for the following dispositive actions:[68]

Dispositive Action:		Number
Privatization	-	123
Conversion	-	5
Regularization	-	17
Retention	-	78
Consolidation	-	18
Abolition	-	58
Sub-Total	-	299
(For Further review		2)
Total		301

It is to DBM's credit that formerly conflicting ballpark figures in the headcount of GOCCs and their subsidiaries have been pegged down to real terms. However, DBM was faced with "new discoveries " as its teams took

a closer look at each individual charter that occasionally revealed a " hidden" subsidiary. It would not be farfetched to expect a slight change in the "official" figure of 301 GOCCs which are listed by DBM.

X. TOWARDS PERFORMANCE EVALUATION OF GOCCs

A. The Government Corporate Monitoring and Coordinating Committee (GCMCC)

Another major thrust of the corporate sector reform program calls for the close monitoring of the GOCCs to be retained to be carried out by the GCMCC. Executive Order 236 strengthened this agency with broad powers and functions that exceeded that of its predecessor (the defunct GCMC which confined itself to monitoring). Under the Committee is composed of the Executive Secretary, the Department Secretaries of Transportation and communications, Finance, Agriculture, Public Works and Highways, Environment and Natural Resources, Trade and Industry and the NEDA, the chairmanship of which rotates among the members. The Committee is tasked with :

1. establishment of performance criteria, targets and standards for GOCCs and their annual review of performance;

2. recommendation of financial sanctions and controls over GOCCs to the President;

3. Monitoring of audit recommendations

4. Issuance of guidelines rules and regulations for GOCCs' corporate plans.

Initially, eighteen GOCCs were placed under the Committee's direct supervision; the number has since been increased to 25. The GCMCC is assisted by a Secretariat currently based at the Central Bank building. This core group of approximately 30 personnel together with a few from the Corporate Affairs Group of the Department of Finance (DOF-CAG) operate under the supervision of the Undersecretary of Finance Diosdado Macapagal Jr. and Assistant Secretary Juanita Amatong. By consensus, the Committee created a Technical Board that serves as a clearing house for technical matters before they are brought to the Committee for decision-making.

The objectives of monitoring and coordinating the GOCCs as defined in the Executive Order are the following:

a) to enhance public accountability in the GOCC operations

b) to promote efficient allocation of resources
c) to instill financial discipline and promote financial self-sufficiency among the affected GOCCs
d) to integrate the plans and programs of GOCCs with goals of government policy.

Considering these gargantuan objectives, the need for technical assistance surfaced. In February 1989, the Asian Development Bank funded a Technical Assistance Project for "Monitoring and Evaluating the Performance of State-Owned Enterprises -Philippines". Consultants to the Project were provided from a Canadian firm, Cowater International and a local counterpart, the Economic Development Foundation (EDF).

At this point, some observers of public policy may ask: apart from the externalities of the corporate sector reform program, why has government responded positively to the call for monitoring and evaluating the performance of GOCCs?

Under the Aquino administration, the first step was to implement the policy of privatization which has been initiated even under the previous regime. Privatization however requires that there be potential buyers and a capital market to absorb the enterprises for sale. As described in the previous chapters, the implementation problems of the policy caused the search for alternatives to privatization. In many countries, the improvement of the performance of the retained corporations has remained to be the only avenue open[69], considering the amounts invested by government as sunk costs. This avenue in turn opens the door that can lead to the happier experience of "turning- around" the performance of ailing corporations or increasing the profit margin of the better-faring ones. Improved performance can be achieved through the institutionalization of performance evaluation system (PES), coupled with an effort to enhance the managerial capability of those manning these corporations.

The ADB Project Team recognizes performance evaluation as a systematic and potentially effective approach to dealing with the endemic problems of bureaucratic inefficiency and ineffectiveness. Furthermore, the evaluation of the performance of a person or of an organized group of persons is a very sensitive and challenging activity.

The ADB report states[70]: "In countries that have achieved some success in establishing a PES, an intensive lengthy program was undertaken to publicize and sell the benefits of the system, as well as the implicit cost of carrying on without such a system". The selling period took a full year in Pakistan, about a shorter period for Korea but nevertheless, the campaign for acceptance has made PES a wave of the future. Even for the countries who have faced the problem of dealing with the sensitiveness of the Asian

temperament, PES appears as one of the most viable alternatives to privatization. The Asian aversion to confrontation requires a strong support system from the highest echelons of government and any sincere attempt at institutionalizing PES is likely to fail without this support.

The experience of other Asian countries has brought to light certain interesting dimensions in the course of establishing a PES. One of these dimensions is the duality of purpose of public enterprises that often puts the issue of financial profitability on a collision course with the issue of social profitability.

In Malaysia, MARA is one of the corporate entities created to implement the objectives of the New Economic Policy. MARA implements four major programs for the creation of a core of entrepreneurs, primarily for the Bumiputra: training and education, financial assistance, business development and corporate investment. The traditional PES yardstick of commercial profitability is not applicable in this case. where the more important consideration is the socioeconomic role that has been assigned to the public enterprises. Malaysia, however, has not shelved public accountability aside to hide the dismal performance of some of its losing corporations. Rather it has embarked on a continuous analysis of why losses occur. In spite of the lack of administrative and managerial expertise to provide the much-needed performance evaluation, it has set up a special unit under the Prime Minister's Office to handle the PES.[71]

In India, the problem of providing fertilizer at affordable prices caused the creation of a pricing committee that ultimately affected changes in pricing policies. Public enterprise management recognized its social responsibility and successfully merged it with decreased returns on capital supplemented by an increase in the efficiency of fertilizer plant management.[72]

A case writer on Sri Lanka[73] laments that "top management posts in public enterprises are filled with persons without aptitude but with strong political backing". He adds that appointment of the right persons and the organized effort at management training and development will go a long way towards reducing losses and improving the profitability of the enterprises.

All these country paper testimonies contribute to the value of PES as the solid alternative to divestiture. Other support systems to PES are of course necessary such as corporate planning, management information systems and early warning devices that can give the signal to public enterprise managers the necessity of using safety and remedial measures to increase productivity and decrease losses.

B. The Performance Evaluation Project of DOF-ADB

The Project Team divided the task into six components, namely: the corporate performance evaluation system (PES); the Early Warning Monitoring System (EWMS); Corporate Planning; Reporting of Corporate Information; Processing of Corporate Information; and Training.

After preliminary conferences with officials and staff of the Secretariat, the Training Consultant recommended that the training module start with in-house training for the staff. A series of seminar-training was pursued that included among other modules team-building, and skills enhancement (e.g. financial analysis, forms administration, etc.). With more skills, the new Secretariat staff has established better rapport with the agencies the Committee supervises. Training activities have spilled over to the management side. With participation from the agency, the Management Information System established has resulted in the reduction of the number of forms used from 153 down to 78.

The project team has limited the scope of their work to the provision of recommendations for performance targets, measures and weighings , as well as a framework for corporate plan preparation. Other results included a series of recommendations that may contribute to the strengthening of the Committee:

1) The call for strong support and commitment to the performance evaluation system to be established from the President and members of the Cabinet. What is perceived to be internalized is a "sense of urgency" about the PES institutionalization.

2) Identification of prerequisites for the successful implementation of a PES and these are :

   a. the availability of adequate information primarily from the Commission on Audit and the GOCCs themselves taking into account timeliness, relevance, completeness, accuracy and consistency of information.

   b. the creation of an independent review agency that would enhance the credibility of the PES. The report envisions a Performance Evaluation Committee (PEC) as an independent senior advisory committee to the GCMCC. The PEC is to be composed of non-Government members with "distinguished background". To provide support to the PEC is another group to be created composed of senior level analysts as part of the

GCMCC Secretariat, to be known as the Performance Evaluation Group (PEG).

c. A system of incentives for the GOCCs themselves upon attainment of certain criteria, as yet to be determined.

d. Strong support from Government through the placement of GCMCC directly under the Office of the President. A senior OP official would then chair the Committee.

e. A relatively uncomplicated system of performance measures.

These performance measures are unique to each public corporation; they seek to focus financial managerial attention on their respective key result areas. Examples of these measures arrived at as ratios are: debt service, debt equity, return on asset, operating current, credit guarantees leverage, collection and billing, credit insurance renewal, etc.

Initial reactions to the ADB Project Team's study point out that no insight was provided into the social accountability aspect of public corporations. Perhaps due to time constraints, and the more technical expectancies from the report, that aspect was not included. As mentioned earlier, the scope of the work was limited to the framework and more general recommendations for performance targets and measures, leaving out specifics at the agency level. Nevertheless, the study may be taken as one big step towards the institutionalization of PES in the public corporate sector.

C. The Prospects for Performance Evaluation of GOCCs

John Howard[74] hold the popular view that public enterprises are development institutions. He also postulates that GOCCs must be viewed beyond their traditional role as instruments of the State or of the market: "In order to implement the new strategies (of Development), public enterprises must be seen as institutional fiduciaries, entrusted by the community, through Government, with resources to be used for the well-being of specified beneficiaries..." adopting a process of law whereby public enterprises are held accountable for the social impact of its activities. This right of the intended beneficiaries to demand performance from the enterprise need not be based on statutes but on the fiducial obligation of the enterprise towards the beneficiaries.

Thus, PES gains acceptance as an instrument of public accountability but not so for its concomitant controls and regulatory conditions. When agencies fail to submit documents as requirements of GCMCC, the latter

does not have the necessary clout to impose sanctions and penalties, except through the Office of the President , and in spite of the explicit provision under Section 5.

DOF Assistant Secretary Amatong[75] recommends placement of GCMCC under OP supervision. COA Associate Commissioner Sofronio Ursal[76] is wont to give GCMCC more support through the COA version of the proposed Corporation Code. "We placed great emphasis on GCMCC to provide direction, monitoring and control".

Government's control orientation does not, however, sit well with corporate management. National Power Corporation's Vice President for Administration Perla Segovia[77] quips: "The whole objective of monitoring, coordinating and supervising GOCCs is for Government to ensure that they perform. Why can't the executive delegate the widest possible latitude of autonomy to the corporate board and management and then exact full accountability for overall results or performance from them?" She calls for the review of the " existing labyrinthine organizational arrangements for supervision over the GOCCs.

Following this line of thought, neither does the GCMCC Secretariat respond positively to the ADB Project Team's recommendation in installing a PEG within its ranks. Perceptions range from "additional bureaucratic layer" to potential source of irritation considering its unresolved nagging problems of staffing, adequate office space and lack of support from the higher officials.

All interviewed sectors however agree that PES is necessary for GOCCs to operate more efficiently and achieve their common objectives of providing services or goods as a government instrument for development.

XI. Policy Dilemmas of GOCCs

The Policy Study Series also include studies on policy dilemmas which are now the subject of debate and discussion. Among these are:

1. PAGCOR as a major revenue source for government
2. Disposition of selected operations of public utility corporations
3. The role of GOCCs in creating livelihood opportunities
4. Organizational arrangements for coordinating and monitoring government corporations

5. The role of government corporations in stimulating private investments

6. Franchising and other options for rationalizing government corporations

7. Extent and boundaries of involvement in strategic industries

8. Balancing flexibility and accountability in government corporations

Findings from the above studies indicate that some widely held assumption about GOCCs need reexamination. For example, the dominant view that GOCCs are crowding out private investors may not be completely valid. Also, franchising and contracting out are generally accepted as effective "load-shedding" options for GOCCs. Case studies of GOCC experience on these options indicate that unless effectively regulated, franchising and contracting out will create new problems as old ones are purportedly solved.

It has also been assumed that flexibility and accountability for GOCCs may not be complimentary. The study on this subject comes out with the finding that the two can be achieved as long as control systems focus on end results and performances, and not on day to day operations.

Each of the above policy studies have specific recommendations for the consideration of policymakers.

XII. Towards a Meaningful and Relevant Policy on GOCCs

The study concludes that some changes may be needed in GOCC policies to make these more responsive and relevant to current public expectations. Thus, the following issues are raised:

1. Should privatization continue to be the centerpiece of corporate reform and rationalization?

2. How do we resolve the dilemma of reconciling demands from the international environment and issues of national interest?

3. Poverty is a pervasive problem which is supposed to be the focus of government programs and projects. What is the role of government corporations in alleviating continuing poverty in the country?

4. What policy measures should be undertaken to integrate performance evaluation into the GOCC sector?

5. The decade of the nineties calls for consultation transparency and democratization in policy formulation. Should mechanisms for consultation be included in policy formulation for GOCCs?

XIII. Suggestions Towards Reframing GOCC Policy

At the beginning of this paper, it was necessary that a policy framework is the result of the interaction of three major factors: the environment, the policy stakeholders and the policies themselves. It was likewise noted that insofar as the environment was concerned, external institutions played a major role. Among the stakeholders, employees of GOCCs and clientele of these corporations had the least participation. Public consultations were not made. Such a situation was understandable, considering the economic and political climate from 1983-86.

It was therefore recommended that efforts at reframing GOCC policy should provide for mechanisms which will consider the contending forces in the environment and among the policy stakeholders.

It is in the light of the findings of this paper that the following suggestions towards reframing GOCC policy is made.

A. Start from the Constitution

It must be recognized that GOCCs are here to stay. The 1986 Constitution says so. Certain functions and responsibilities of the state can be achieved more effectively, using the corporate form. Also, the crucial role of GOCCs in national development has to be given importance. At the same time, the Constitution, in broad terms, sets forth the conditions under which GOCCs can be formed.

B. Reformulate Basic GOCC Policy Declarations

1. Among others, P.D. 2029, 2030, Administrative Order 59, Proclamation No. 50 and 50-A need to be reviewed and reformulated, to respond to new policy options and expectations from the environment and GOCC clientele.

2. Reexamine the question of when GOCCs should be created. The Constitution gives broad guidelines but these have to be fleshed out in terms of what is considered the national interest. Also, there is a need for a periodic review of interpretation of what is the national interest, and what is considered strategic.

3. As stated in No. 1, the proclamation on privatization need to be reviewed, taking into consideration actual problems in implementation. Also, the more meaningful objectives of privatization, e.g. dispersal of ownership of GOCCs and assets; increased efficiency; breakup of monopolies, whether public or private; protection of workers rights, etc. need to be expressly stated in the proclamations.

In particular the anti-worker provisions on the proclamation have to be repealed, especially since the present leadership of APT, COP, and the Department of Labor have publicly expressed concern for protection of worker's rights.

4. There is a need to refocus GOCC policy towards performance evaluation. The various policy studies invariably point to the necessity of performance evaluation as a mechanism for assuring efficiency and accountability.

Nevertheless, the following should be considered:

a. consideration of non-financial criteria

b. consideration of social and political accountability

c. mechanisms for assuring public participation in performance evaluation

d. there is also a need to take a second look at the concept of differential treatment in the light of specific policy recommendations on flexibility and accountability

5. Likewise, there is a need to reconsider other assumptions explicitly stated in the existing issuances in the light of the findings of policy studies, e.g. findings on the supposed crowding out of the private sector by GOCCs, effectiveness of tax incentives, efficiencies of franchising and contracting out, etc.

6. On non-privatization modalities, the guidelines suggested in the policy studies for contracting out, franchising and disposition of certain public utility operations may be considered.

7. Likewise, the suggested guidelines on administrative arrangements may be considered.

8. Finally, there is a need to review the implementation of the concept of departmental attachment.

C. The case of performance evaluation has been repeatedly stressed. However, such cannot be effective without a thorough review of the laws, regulations, requirements and other rules which are overlapping, repetitive and hamper effective performance of the mandated functions of GOCCs. This call has been made on many occasions and under different circumstances.

D. Present GOCCs policies were formulated primarily by the executive in cooperation with multilaterals. There is a clear need for the executive branch to coordinate with the legislature on policy issues. This is necessary in the light of the fact that the legislature has been enthusiastically churning out bills and resolution affecting GOCCs.

E. Even more important, mechanisms for public consultations have to be established. This is in line with the thrust towards transparency and democratization in Philippine society.

Concluding Remarks

As stated at the beginning of the chapter, GOCCs policies were formulated in an environment which has changed in the space of a mere four years. In 1985 and 1986, the official mood towards GOCCs was far from sympathetic. International pressure was for practically doing away with the GOCC sector. Privatization was the order of the day.

Things have changed. Actual experience and recent events have opened options and new policy directions. The time has come to initiate change in GOCC policy.

ENDNOTES

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[12]Manasan, Rosario, *An Assessment of Fiscal Policy in the Philippines, 1986-1988,* 1990 PIDS Working Paper No. 6.

[13]*Ibid.*

[14]Briones and Zosa, *"Asset Privatization: The Philippine Experience"*, FAFI Monograph No. 1 Fiscal Administration Foundation, Inc. 1989, p. 33.

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[16]*Ibid.* p.34.

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